The Emerging Fixed Cramdown Rate Regime: A Market-Driven Argument for Effective Fixed Rates in Bankruptcy Cramdown

Michael E. S. Frankel

Follow this and additional works at: http://chicagounbound.uchicago.edu/roundtable

Recommended Citation
Available at: http://chicagounbound.uchicago.edu/roundtable/vol2/iss2/12

This Article is brought to you for free and open access by Chicago Unbound. It has been accepted for inclusion in The University of Chicago Law School Roundtable by an authorized administrator of Chicago Unbound. For more information, please contact unbound@law.uchicago.edu.
Chapter 11 of the Bankruptcy Code\(^1\) (the Code) is a delicate statutory dance that balances an effort to resuscitate the debtor corporation against a desire to protect the interests of its creditors. In the ideal chapter 11 world, all concerned parties would unanimously approve reorganization plans. However, a system that depended upon unanimous approval would allow any individual creditor to hold a reorganization plan hostage and either block the reorganization or extort a fee for its approval. At a minimum, such a system would result in increased bargaining costs, and at worst it would create bargaining failures that would prevent efficient reorganizations. The Code provides a protection against this sort of behavior by allowing the court, under certain circumstances, to "cramdown" a reorganization plan on unwilling creditors.\(^2\)

These cramdown proceedings raise an important question: when courts cramdown a reorganization plan, what interest rate should they impose on secured creditors? Courts have largely taken a discretionary approach to this problem. They have employed several related methodologies to gauge the correct interest rate for each particular fact pattern before them.

One advantage of this discretionary approach is that it allows courts to more accurately match cramdown interest rates to the risks associated with particular debtors. To the extent that secured creditors are "innocents" in the cramdown process,\(^3\) this accuracy provides the most equitable result because

---

Michael E. S. Frankel received his J.D. and M.B.A. in 1995 and his B.A. and M.A. in 1990 from the University of Chicago.

2. 11 USC § 1129(b).
3. This view of secured creditors is suggested by the coerced loan theory of cramdown, which is discussed in Section I. Under this theory, a secured claimant in cramdown should be viewed as though she were a third party coerced to provide a loan to the reorganized firm.
it compensates secured creditors for the risks they incur by continuing to hold a claim against the reorganized firm. However, this accuracy comes at a price. The discretionary approach requires a case-by-case fact inquiry which can be costly and time-consuming. Furthermore, under this approach, when ex ante creditors and debtors negotiate a loan, they face significant uncertainty about the potential costs of bankruptcy and reorganization.

This Comment examines the advantages and disadvantages of various discretionary approaches courts have adopted. It will argue that courts should determine cramdown rates with an alternative rules-based approach. After courts satisfy the basic requirements of the statutory language, they can calculate cramdown rates by focusing on ex ante effects rather than on a search for case-by-case accuracy. This approach implies that the cramdown rate should be fixed or linked to a particular predictable standard (e.g., the contract, prime, or treasury rate). While the proposed approach may be less accurate at a case-by-case level, this Comment will argue that a predictable cramdown interest rate allows parties to adjust their contracts ex ante to reflect the risks and costs of a cramdown. Thus, a perfectly or highly predictable cramdown interest rate may yield results similarly equitable to those achieved under a discretionary approach. Further, this rule-based approach is less costly and time-consuming than a case-by-case inquiry. This Comment concludes by examining the likely consequences, positive and negative, of a shift by bankruptcy courts to such a rule-based approach and the factors that should drive the choice of the particular fixed rate.

I. The Current Approach to Cramdown Interest Rates

According to chapter 11 of the Code, a reorganization plan must pass the "best interests of creditors" test. That is, each member of an impaired class who holds a claim must approve the plan, or the plan must provide each such claim holder with not less than the amount she would receive in a chapter 7 liquidation. Under the cramdown provision, the court may confirm a reorganization plan even when an impaired class objects, as long as the plan does not discriminate unfairly and is "fair and equitable" with respect to the class that has rejected the plan. "Fair and equitable" is a term of art upon which the Code expands. The common law basis for the term is found in

4. Read strictly, the cramdown provision only requires that the discounted payment stream received equal the net present value of the claim, without taking into account any "risk" variables. Under this reading, the present value requirement is simply a baseline that mandates that the creditor receive no less than an unadjusted base market rate of interest.

5. "A class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan leaves unaltered the legal, equitable, and contractual rights" under such a claim. 11 USC § 1124. See also George M. Treister, et al, Fundamentals of Bankruptcy Law, 430 (ALI, 3d ed 1993).


8. Id (b)(1).
Northern Pacific R. Co. v Boyd. In Boyd, the Court held that it would not sanction any plan in which subordinate rights are secured at the expense of the prior rights of other security holders without the consent of the parties affected. To do so, the Court held, would be unfair and inequitable. Thus, the absolute priority of claims in bankruptcy will be enforced with regard to parties that have not consented to a plan of reorganization. Since Boyd, the phrase "fair and equitable" has indicated that a reorganization plan satisfies the absolute priority rule.

In addition to the Boyd standard, the Code imposes additional requirements. To qualify as "fair and equitable" with respect to secured creditors, a plan must provide that holders of secured claims retain their liens and receive deferred cash payments that total the amount of their claims (face value) and at least the value of their interest in the estate's property (present value). Therefore, when courts determine the interest rate to impose under cramdown, § 1129(b)(2)(A)(i) and particularly the language that refers to "deferred cash payments . . . [in the amount of] of such claim," drives their inquiry. When courts apply this section of the Code, they focus primarily on the merits of different methods to calculate the present value of the secured claim. While a variety of such methods have emerged, all employ a discretionary approach that seeks to obtain the correct interest rate based on the particular fact patterns before them.

9. 228 US 482 (1913).
10. Id at 502.
11. Id.
15. Id (b)(2)(A)(i)(II). It is important to note that, barring negative interest rates, it will be rare for the face value requirement to be a limiting factor since the face value of a note will not include the interest payments that would be required under a present value calculation.
16. Id.
17. Additionally, the Code requires that the secured creditors receive the "indubitable equivalent" of their claims. Id (b)(2)(A)(iii). This concept is rooted in the opinion of Judge Learned Hand in In re Murel, 75 F2d 941 (2d Cir 1935), and was designed to broaden the range of solutions available to debtors and creditors in bankruptcy. In re Briggs, 780 F2d 1339, 1346 (8th Cir 1985). The court in Murel specifically stated that "a creditor who fears the safety of his principal will scarcely be content with [interest payments alone]; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that . . . unless by a substitute of the most indubitable equivalence." In re Murel, 75 F2d at 942. The key word in this language is "substitute." In the Matter of Sandy Ridge Development Corp., 881 F2d 1346, 1350 (5th Cir 1989). However, the Court has noted that the right to receive the present value of a secured claim under § 1129 derives from § 1129(b)(2)(A)(i)(II) and not from the "indubitable equivalence" language in § 1129(b)(2)(A)(iii). United Savings Assn. of Texas v Timbers of Inwood Forest, 484 US 365, 377 (1988).
18. See text accompanying notes 26-44.
19. Id.
The discretionary approach is supported by the coerced loan analogy adopted by many courts. Under this approach, when courts choose a cramdown rate, they examine the merits of variables, which include level of risk and bankruptcy cost, as well as baselines that include the prime rate and the original contract rate. As a result, courts have used widely varying levels of complexity and quantitative sophistication in their interest rate models.

Courts have taken three primary approaches to choosing a cramdown interest rate. Under the first approach, courts attempt to price the costs a creditor would incur to replace the funds tied up in the coerced loan. Under the second approach, courts attempt to price the coerced loan made to the debtor. Recently, courts have begun to move away from these two discretionary approaches in favor of a formula method.

All three approaches have the advantage of accuracy in matching cramdown interest rates to the risks associated with particular debtors. However, it is important to note that the primary assumptions in all three approaches are that the goal of the court is to achieve the greatest possible case-by-case accuracy and that the court can achieve such accuracy only when it examines the particular facts and equities of each case.

A. THE COST OF FUNDS APPROACH

Under the cost of funds approach, courts seek to compensate the secured creditor for the costs of raising the funds that the secured creditor would otherwise receive in liquidation. This approach is based on the presumption that the secured creditor will need to replace the funds that she expected to receive immediately rather than simply waiting for the debt to be paid, perhaps...
over time, after the debtor emerges from bankruptcy. As explained in *Collier on Bankruptcy*, "[t]he appropriate discount rate is one which approximates the creditor's cost of funds in its business borrowings. If the holder of an allowed secured claim receives interest which compensates it in full for any additional interest costs incurred due to the deferral of payment, it is not harmed by that deferral."26

There are several internal problems with this approach. First, a standard based on the particular creditor's cost of borrowing involves a case-by-case fact inquiry. Second, it is doubtful that the secured creditor has an unlimited supply of credit.27 Third, by focusing on the cost of replacing funds, this approach may ignore the risks associated with the cramdown itself. There is likely some correlation between the interest rate a secured creditor can receive in the market and the degree of its involvement with the debtor. The larger a position the secured creditor has with the debtor, the higher the rate the debtor will be charged under this approach.

Suppose there are two secured creditors, A and B. They are identical in all respects except that A has 100 percent of her assets invested in a secured loan to the debtor while B has only 50 percent of her assets invested in a secured loan to the debtor, the other 50 percent invested in liquid assets. A will certainly have a higher cost of capital than B and will pass this cost on to the debtor in the form of a higher cramdown rate. But the higher rate that A receives is unjustified. Both creditors hold equally risky security interests, yet by virtue of its percentage holdings, A receives a higher rate. Under such a system, debtors have an inefficiently low incentive to diversify their security interests because they can receive a higher cramdown rate with a less diversified portfolio.

Some courts have avoided these problems by abstracting the particular characteristics of the creditor.28 Instead, they choose a particular standard market measure like the Treasury bill rate, or the prime rate, thus producing a simple fixed rate rule.29 However, it is unlikely that the cost of additional funds for most creditors is accurately represented by these market rates since there is presumably a wide variance of creditworthiness among the total pool of potential creditors.

Even if the internal problems with this approach are resolved, there is a more fundamental issue. The language of the Code is directed at the value of the secured creditors claim, not at their cost of capital. While one could make an argument that in a liquid capital market, the cost of capital would be an approximate surrogate for the discount rate applicable to a deferred payment stream, it is an indirect and imperfect surrogate. A variety of other variables can differentiate the value of the secured creditors claim from the cost of obtaining additional capital.30 Thus the cost of capital approach internalizes issues relating to the

29. Id. See also *In re Jordan*, 130 Bankr 185, 191 (Bankr D NJ 1991).
30. The value of the secured creditors' claim can be affected by such variables as the
B. The New Loan Approach

Other courts have adopted a new loan approach, achieving similar results. The new loan approach is grounded in the coerced loan theory; it attempts to give the secured creditor an interest rate equal to that which the creditor would have otherwise received in the market. The Fourth Circuit has accepted this approach, first tacitly in In re Bryson Properties and then explicitly in United Carolina Bank v Hall. In United Carolina, the court held that "the business opportunity that the secured creditor might otherwise have been able to pursue best determines the present value of the allowed secured claim" that is deferred under the cramdown provision. The proper rate under this approach is derived from the particular lending market in which the secured creditor operates. The Fourth Circuit also agreed with the ruling of the district court below, capping the cramdown rate at the original contract rate, to eliminate any windfall benefit to the secured creditor. Thus, the secured creditor bears the risk of a drop in the market rate but does not receive any benefit from an increase in the market rate above the contract rate.

In adopting the same approach, the Tenth Circuit opined in In re Hardzog that the new loan approach is superior to both the market-rate or formula approach and the cost of funds approach. The new loan approach does not require a complex fact inquiry; rather it piggybacks upon the expertise and efforts of professional lenders. The court held that bankruptcy courts should use "the current market rate of interest used for similar loans in the region." It found a basis for this approach in the new/coerced loan theory and in the belief that such an approach would yield a fair result for both debtor and creditor "with neither receiving an advantage over the other." The Tenth Circuit does leave open a potential exception to this rule for an undefined set of

quality of the assets that secure it and the likelihood of successful reorganization.

32. United Carolina, 993 F2d at 1131.
33. Id.
34. In United Carolina, the court looked to the new mobile home (the collateral in which the security interest was held) financing market. Id at 1126. However, the court noted that the rate given to the secured creditor should be the net rate that it would have received, rather than the gross rate (including related costs and fees) that the debtor might pay. Id. In particular, if the secured creditor purchases the finance contracts from a third party at a discounted rate, it is this discounted rate, rather than the rate paid by the debtor, which should be employed. Id.
35. Id (citing In re Mellema, 124 Bankr 103, 107-08 (Bankr D Colo 1991)).
36. See text accompanying notes 44-56.
38. In re Hardzog, 901 F2d 858, 860 (10th Cir 1990).
39. Id.
40. Id.
While the Tenth Circuit does not cite to the case directly, it appears to have drawn the language of its holding largely from a decade-old decision of the Sixth Circuit. In *Memphis Bank v Whitman*, the Sixth Circuit held that “in the absence of special circumstances bankruptcy courts should use the current market rate of interest used for similar loans in the region.” It subsequently reiterated this rule in *US v Arnold*. There it held that in a cramdown, where the secured creditor is forced to write down a portion of its note, the creditor is entitled to receive the current market rate for similar loans on the “new loan.”

While the Third Circuit adopted a similar approach, it hedged when it held that the appropriate rate of interest is the rate “currently being charged by the creditor in the regular course of its business for loans similar in character, amount and duration” but noted that it is appropriate for a bankruptcy court to use the contract rate as the default rate in the absence of any evidence to the contrary.

While the argument can be made that the current market rate for similar loans is a surrogate for the appropriate discount rate, the new loan approach introduces characteristics of the particular sub-market for loans, and the particular industry, that are not relevant to the value of the secured creditors interest in collateral.

C. THE FORMULA APPROACH

1. Judicial use of the formula approach.

In the more recent formula approach, courts use a risk-free interest rate base and then add a risk premium. This approach uses variables that, at least theoretically, equal the present value of a payment stream that can match the value of the secured creditors' claim. The base rate is usually a common market rate (i.e., prime rate or treasury rate); the court assigns the risk premium. A pattern has developed whereby courts peg the risk premium within a small range.

Since the court looks to the prevailing market in the region for the same type of loan to determine the risk premium, the Eighth Circuit decision in *US v Doud* suggests that this approach can be viewed as a quantification for the cost of funds approach. However, conceptually this approach is entirely different. While the Eighth Circuit has made reference to examining the “prevailing market rate for a loan of a term equal to the payout period,” the final test it developed

---

41. Id.
43. Id at 431.
47. Id at 1521.
48. Id at 1517.
49. *Doud*, 869 F2d at 1146.
is unlike the approaches discussed above. Rather, the Eighth Circuit is more properly grouped with those courts that have chosen the formula approach.

In large part, the decision in *Doud* is based on the Eighth Circuit's prior decision in *Monnier*. In *Monnier*, the Eighth Circuit held that since the contract was relatively recent, the contract rate did presumably reflect the prevailing cost of money as well as the inherent risks of the contract. While the decision uses the language of the cost of funds, it has the underlying structure of the formula approach. The court found that the contract rate is the appropriate base rate and that there were no additional risks to merit a risk premium. An underlying assumption in the court's analysis is that the risks that are relevant to the risk premium do not include the risks inherent in bankruptcy itself. Specifically, the court referred to "the prospects for appreciation or depreciation of the value of the security, and the risks inherent in a long-term agricultural loan" as those relevant risks which were reflected in the very recent contract rate.

In *Camino Real*, the Ninth Circuit explicitly endorsed a case-by-case approach similar to the cost of funds approach taken by the Fourth, Sixth, and Tenth Circuits. However, in doing so, the court upheld what appears to be a formula approach (rather than a case-by-case approach) by one of the lower courts. In a subsequent case, the Ninth Circuit removed any ambiguity by explicitly endorsing the formula approach. The court held that the cramdown rate should be derived from a base rate, either the prime rate or the rate on treasury obligations, and an additional factor based on the risk of default and the nature of the security (the risk factor).

The formula approach requires the courts to undertake a rather detailed factual inquiry to choose the risk premium. The result is a numerical "mini-trial" on the risk premium issue. In addition to the costs of conducting such an inquiry, there may be a tendency by the court to "split the baby" between rates proposed by the debtor and creditor. In *In re Oaks Partners, Ltd.*, the court appears to split the difference between the debtor's 1.5 percent to 2.5 percent proposal and the 4 percent to 5 percent proposal of the creditor, arriving at a 3 percent risk premium.

Courts present a variety of potential baselines and variables to assess the risk premium, but there is no uniformly accepted formula. This approach does attempt to employ variables that are directly relevant to the value of the secured

50. Id (citing *In re Monnier Bros.*, 755 F2d 1336, 1339 (8th Cir 1985)).
51. *In re Monnier Bros.*, 755 F2d at 1336.
52. Id at 1339.
53. Id.
54. Id.
55. *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F2d 1503, 1508 (9th Cir 1987).
56. Id.
57. *In re John Fowler*, 903 F2d 694, 698 (9th Cir 1990).
58. Id. For an extensive list of cases using the formula approach, see Friedman, 14 Cardozo L Rev at 1516-17 nn 84-85 (cited in note 46).
creditor's claim in the form of a deferred payment stream. However, the formula approaches require significant fact inquiries, and it is not clear that they will provide particularly high accuracy.

Courts have responded to these inherent limitations by limiting the extent of the necessary factual inquiry, tightening the scope of the inquiry, or creating a default rule. For example, most courts have given little weight to the particular characteristics of the debtor or creditor. Specifically, courts have refused to consider the creditor's lending policies, cost of funds, tax problems, or age.

The potential for a court to limit the scope of the inquiry is demonstrated by the decision in Monnier. There, the court strictly limited the inquiry to the question of whether the market rate for similar loans had changed since the contract date (it had not), whether there had been changes in the value of the security, and whether there were risks unique to a long-term agricultural loan. The court assumed these last two were reflected in the contract rate. Since the risk premium is based on a hypothetical transaction between generalized creditors and debtors, a court can use a formula approach and still reach a market or contract rate result. This is particularly true since most courts have begun to adopt a single fixed risk premium. In a recent and relatively exhaustive study of bankruptcy decisions, one commentator noted that “[n]ot one of the reported decisions, discussing what ‘risk factor’ should be added to a base rate, has even analyzed the probability and magnitude of actual risk. Decisions may generally discuss the condition of the debtor or the collateral . . . but an objective basis for quantifying the risk factor is rarely developed.”

The use of a default risk premium is an increasingly popular method of eliminating the need for a complex fact inquiry. The court in Doud recognized and approved a movement by lower courts in multiple jurisdictions to adopt a default risk premium of 2 percent. The Doud court deferred to the bankruptcy court's conclusion that a 2 percent risk premium “would adequately compensate a conventional lender for the overall risk associated with a chapter 12 reorganization.” The rule reiterated by the Doud court has in turn been followed

60. Friedman, 14 Cardozo L Rev at 1518 (cited in note 46).
61. See, for example, In re Manion, 127 Bankr 887, 890-91 (Bankr N D Fla 1991).
62. See, for example, US v Neal Pharmacal Co., 789 F2d 1283, 1286 (8th Cir 1986).
63. See, for example, In re Nite Lite Inns, 17 Bankr 367, 372 (Bankr S D Cal 1982).
64. See, for example, In re Mulberry Agric Enters, 113 Bankr 30 (Bankr D Kan 1990). See also Friedman, 14 Cardozo L Rev at 1518 (cited in note 46).
65. In re Monnier Bros., 755 F2d at 1339.
66. Id. at 1519.
68. Id. at 1521.
69. Doud, 869 F2d at 1145. For examples of this approach, see In re Wichmann, 77 Bankr 718, 721-22 (Bankr D Neb 1987) (yield on treasury bond plus a 2 percent upward adjustment to account for the risk was adopted as prevailing market discount rate with recognition that special circumstances may exist in some cases for departure); In re Bergbower, 81 Bankr 15, 16 (Bankr S D Ill 1987).
70. Doud, 869 F2d at 1145 (citing In re Doud, 74 Bankr 865 (Bankr S D Iowa
by other courts. However, many courts continue to use a discretionary risk premium in their application of the formula approach.

2. An alternative version of the formula approach.

The courts could adopt the formula approach and simplify it further by replacing the discretionary risk premium with a discrete set of variables that are easy to calculate. This simplification would not undermine the central theme of present value, which underlies the congressional intent behind the cramdown provision. The relevant House Report states that the Code "contemplates a present value analysis that will discount value to be received in the future." The Congressional Record provides little additional clarity on the question of how to price the deferred payment stream under cramdown. It has been interpreted as simply noting that the court can impose cramdown if members of the dissenting class receive "property of a value equal to the allowed amount of their secured claims." A plain language interpretation of the statute and Congressional Record suggests a simple payment stream discounted to reflect the time value of money in the current economy, without any additional fact-based considerations.

Presumably, the economic premise of this approach is that a secured creditor in cramdown faces no true default risk. Since the secured creditor retains a lien on the secured collateral, a future default by the debtor would simply result in an exercise of the lien, and thus the secured creditor would realize the liquidation value of the collateral. To be just as well off as under an original chapter 7 liquidation, the secured creditor must simply be compensated for the change in value between her share of an immediate liquidation and an uncertain future liquidation. To this end, the secured creditor would have to be compensated for depreciation in the collateral and the risk that the collateral would be damaged, wasted, or destroyed while in the hands of the debtor. The secured creditor might also seek advance compensation for the potential costs involved in exercising the lien in any subsequent bankruptcy proceeding. All of these variables are quantifiable. The depreciation costs of the collateral should be easy to ascertain. The risk of damage will be equal to the cost of insurance (thus the debtor would effectively have the choice of insuring the collateral or paying the cost of insurance to the secured creditor). Finally, the costs of future bankruptcy proceedings could either be assessed as an additional secured claim at the point of filing or

1987).  
72. See Friedman, 14 Cardozo L Rev at 1516-17 nn 84-85 (cited in note 46).  
given to the secured creditor as a payment stream equalling the future costs discounted by the likelihood of a future filing. Presumably, the court could make an assessment or simply use a general probability. The work done by noted economists suggests that approximately 52 percent of restructuring attempts end in bankruptcy. The opportunity costs of not receiving the value immediately under liquidation, but rather through a stream of payments, should be reflected in the base risk free market rate of interest.

It is more difficult to calculate the harm to the creditor if a debtor wastes or otherwise consumes an asset. However, if this is a standard operation under the debtor's business, there should be some historical data available to calculate the cost of such waste.

Under this proposed alternative formula approach, the court can calculate a cramdown rate relatively easily. Perhaps more importantly creditors and debtors can predict the cramdown rate with relative certainty.

II. Weaknesses in the Current Approaches

The foundation of the methodologies described above is a discretionary approach emphasizing case-by-case accuracy and equity. While the use of default rules and simplified formulas limit the frequency or scope of factual inquiry, judges still have discretion to make such an inquiry.

The primary value of the discretionary approach is the prospect of case-by-case accuracy in assigning cramdown interest rates. This accuracy does come at the cost of a more detailed factual inquiry. However, courts are well versed in such inquiries since, by their very nature, they are faced with a series of individual cases and equities. Rather than emphasizing the net result of the pool of bankruptcy decisions upon the pool of cases, the discretionary approach focuses courts' attention on the equities and facts before them. Even the default rule approach offered by the court in Doud leaves open the possibility of "special circumstances" in which such discretion will reappear.

One might argue that under the discretionary approach, courts interpose themselves more completely into the relationship between the parties by effectively seeking to create a new loan contract based on equitable terms inferred from the facts of the case. However, a discretionary approach is not mandated by the


78. While courts have tended to utilize prime or treasury rates for this base rate, the goal of compensating for lost opportunity costs suggests that a standard commercial rate might be more appropriate. The argument for this approach is similar to that presented in the cost of funds approach. See text accompanying notes 30-33.

79. If the property is not necessary to an effective reorganization of the debtor's business, the creditor may be able to obtain relief from the automatic stay. 11 USC § 362(d)(2)(B).

80. See text accompanying notes 84-91.

81. Doud, 869 F2d at 1145. This emphasis on the specific facts of the case appears to have been bolstered by the adoption of the coerced loan approach.
Code. In fact, the Code emphasizes minimal court involvement. Thus, a less active and case-specific approach may still fulfill the statutory requirements. Further, if a less active approach does not significantly erode the accuracy and equity of the results, the primary goals of the discretionary approach would still be achieved.

There are several factors that limit the accuracy of a discretionary approach and create a high variance in the cramdown rates courts impose. First, there is a significant information problem. I assume here that the judge gets most of her data from the parties. The judge will likely seek a point between the two parties, creating an incentive for the parties to push further and further from the "correct" rate. Under a standard arbitration model, we will have a "split the baby" problem where each side has an incentive to radicalize their claims and the judge is left with widely disparate arguments. Further, certain judges may also have internal biases in their decisionmaking ("pro-creditor" or "pro-debtor" judges). Unless the parties' efforts to influence the judge are balanced and the judge is unbiased, the judge may often arrive at an inaccurate rate. Second, there are also significant questions about the accuracy of court assessments, beyond information problems. While courts make substantial efforts to delve into issues of economics and corporate finance, they often make errors in their effort to understand or explain loan markets and interest rates.

Third, since the judge is primarily concerned with the particular case at hand, rather than in influencing the decisions of the wider population of current non-bankruptcy creditors, there is no check on a high level of variance between different cramdown rate decisions and the decisions of different judges. The decisions are driven by case-specific considerations such as pre-bankruptcy terms and agreements, goals of successful reorganization, and general equity concerns. As a result, when judges exercise discretion their decisions will be driven by these case-specific concerns, rather than the impact those decisions will have on future creditor behavior.

Thus, a discretionary approach does not guarantee case-by-case accuracy, and it is also likely to yield a wide variance in the cramdown rates courts impose.

82. See, for example, Scott, 63 Wash L Rev at 1043 (cited in note 75).
83. Offer arbitration solves this problem by forcing each side to submit a final offer, knowing that the arbitrator will choose the most reasonable one. This creates an "inward" pressure on offers; the offers are pushed together rather than apart. However, this methodology is probably not practical in a bankruptcy context for many reasons including the fact that it is a multi-polar rather than bipolar conflict.
84. See, for example, In re Arnold, 80 Bankr 806, 809 (Bankr M D La 1987) (explaining that aspects of risk are not limited to default but include liquidity risk and inflationary expectations).
85. Scott, 63 Wash L Rev at 1052 (cited in note 75). See, for example, In re Bay Area Servs., 26 Bankr 811, 814 (Bankr M D Fla 1982) (court ordered interest rate calculated by adding 10 percent for inflation to the prime rate, thus double-counting expected inflation which is already included in the prime rate).
III. A Fixed Rate Approach to Cramdown Interest Rates

A. ARGUMENT FOR A FIXED RATE APPROACH

A strong argument can be made for a fixed rate rule as an alternative to the discretionary approaches. Under such a rule, the cramdown rate would be fixed and completely predictable, in the form of either a fixed number or a number based on clear ex ante determinable variables (e.g., the contract rate). The argument is that such a fixed rate rule does not provide a less accurate or less equitable result than the discretionary approach. Moreover, a fixed rate rule enhances the ex ante ability of creditors and debtors to contract efficiently by providing a predictable result in the event of cramdown.

Currently, after ensuring accuracy and equity a court is left to decide where to place the costs of risk associated with the coerced loan. Courts that grant high risk premiums are placing that cost upon the debtor, while courts that are unwilling to grant risk premiums are attaching that cost to the creditor. By providing a risk premium but setting it unrealistically low, most courts appear to split the difference.

If we presume that creditors factor the risks and costs of bankruptcy ex ante into the rates they charge, the only risk which is uncertain is the cramdown rate itself. A fixed rate rule provides creditors with perfect predictability. In a classic statement about the role of legal formalities, Lon Fuller, a noted legal theorist, has pointed to their cautionary and channelling functions. Legal formalities “perform a cautionary or deterrent function by acting as a check against inconsiderate action.” They also perform a channelling function by marking enforceability and therefore inducing deliberation. Thus, a formal rule will induce creditors to factor the fixed rate ex ante into the rates they charge.

In an efficient market, creditors should demand to be compensated ex ante for the risks and costs inherent in a debt contract. Therefore, debt contracts will be priced and structured to reflect the risks and costs of bankruptcy, including the potential for cramdown proceedings and the rates which would apply.

86. Fuller has been referred to as one of the preeminent legal theorists of his time. Geoffrey C. Hazard, Jr., Reflections on Judge Weinstein's Ethical Dilemmas in Mass Tort Litigation, 88 Nw U L Rev 569, 574 (1994).
87. Lon L. Fuller, Consideration and Form, 41 Colum L Rev 799, 800 (1941).
88. Id.
89. Id.
90. A somewhat similar argument has been made in support of a formal rule of contract formulation in the context of the mirror image rule and § 2-207 of the Uniform Commercial Code. See Douglas G. Baird and Robert Weisberg, Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207, 68 Va L Rev 1217, 1231 (1982) (arguing that “because contracting parties have a strong incentive to order their transactions to conform with specific rules, the parties themselves can mitigate the apparent imprecision of these rules”).
92. Thus, the costs of bankruptcy and default are simply redistributed to other debtors.
Under a high cramdown rate, creditors may require lower interest rates and less collateral. In turn, these lower requirements are likely to allow more debtors to seek credit. Similarly, a low cramdown rate is likely to raise interest rates and collateral requirements ex ante and thus reduce the number of loans made. Thus we presume that creditors will adjust interest rates, collateral requirements, and other variables ex ante to account for the risks and costs of cramdown.

This suggests that creditors will be concerned less with whether a cramdown rate is high or low, since the rate will be priced ex ante in the original debt contract, and more with the certainty and predictability of the cramdown rate. This certainty and predictability enables creditors to accurately price the loan ex ante and thus ensure the certainty of the compensation they will receive in the event of cramdown. Thus, a simple fixed rate rule provides superior results because it will produce more predictable outcomes upon which to price debt contracts.

Further, to the extent that we presume creditors and debtors efficiently price the costs of bankruptcy and cramdown ex ante, a fixed rate rule might even provide a similar level of accuracy in measuring the “correct” case-by-case cramdown rate. If a creditor factors the possibility of receiving a fixed and known cramdown rate in bankruptcy into the price of credit charged to a debtor, she should be perfectly compensated in cramdown for the risk she contracted to take. Thus, a fixed rate rule would provide a perfectly equitable and “correct” case-by-case result to the extent that a creditor can accurately price the risks and costs of bankruptcy ex ante.

A fixed rate rule will therefore provide creditors ex post with exactly the entitlements they bargained for pre-bankruptcy. Instead of depending upon the discretion of the judge in determining the rate which fairly provides the creditor with its entitlements, the rate is fixed and creditors are left to bargain with the debtor ex ante for a contract that reflects the fixed rate.

or debtors of a particular class (e.g., a similar risk group to the defaulting/bankrupt debtor) in the form of higher rates for credit and perhaps to other segments of the economy in the form of higher prices for goods. See David T. Stanley and Marjorie Girth, Bankruptcy: Problem, Process, Reform 37 (Brookings, 1971). Except in periods when bankruptcies are increasing so rapidly that lenders are unable to raise credit charges fast enough to earn a normal profit, the creditors themselves are unlikely to bear these costs. Id.

93. Luther Zeigler, The Fraud Exception to Discharge in Bankruptcy: A Reappraisal, 38 Stan L Rev 891, 906 n 63 (1986).

94. Given the large volume of data available on historical bankruptcy proceedings, particularly for large firms, it does not seem unreasonable to assume that a creditor has some ability to price ex ante the risks and costs of bankruptcy. This proposition finds indirect empirical support from the work of Jerold Warner on the pricing of possible departures from the absolute priority rule in bankruptcy. Jerold B. Warner, Bankruptcy, Absolute Priority, and the Pricing of Risky Debt Claims, 4 J Fin Econ 239 (1977). Warner found that the capital market prices debt claims so as to properly reflect “the possibility of deviations from the absolute priority rule.” Id at 272. His findings support the notion that the capital markets and likely individual creditors make consistent efforts to price the risks and costs of bankruptcy.
A fixed rate rule finds support in the legislative history of the Code. In 1952, chapter 11 was actually amended to eliminate the phrase "fair and equitable," and it was replaced by a more limited quantitative test of "whether more was given creditors under the plan than they would receive in liquidation." While "fair and equitable" and its common law construction were re-introduced through the consolidation of chapter 11 with chapter 10 to form the current chapter 11, there is still a strong emphasis on respecting privately negotiated terms. In particular, chapter 11 leaves "the fairness of the plan to the bargain of the parties, with the minimum requirement that creditors receive the liquidation value of the assets." The aim of the Code was thus to create an absolute baseline (the liquidation value of the collateral) from which a largely private bargaining process was to operate. Further, there is no emphasis on the equitable demands of the creditors but only on their baseline right to the liquidation value of their secured collateral.

This suggests an alternative tack for courts to take, focusing on the wider goals of the statute, rather than the individual equities of the case before them. Under this view, after the court satisfies the minimum requirement of liquidation value, it can concern itself with the general goals of the bankruptcy statute rather than the particular equity concerns of the individual debtor or creditor. If this view is adopted, case-by-case accuracy may not even be a relevant concern because the court will not have to focus on the particular facts or equities of the case.

This argument is bolstered by, though not dependent upon, a further assertion that the cramdown provision is directed primarily at affecting ex ante creditor behavior rather than creditor behavior in bankruptcy. For example, since cramdown is forced upon the creditor, the present value requirement likely does not reflect a desire to affect the behavior of a creditor in bankruptcy. However, the cramdown rate will "wash backwards" and be reflected in the negotiated reorganization. Since the Code directly controls creditor behavior in a chapter 11 reorganization, one could argue that the purpose of the cramdown rate is to affect the behavior of pre-bankruptcy creditors. Under this theory, the restated goal of the cramdown provision is to make creditors indifferent ex ante between the prospect of receiving the collateral under a chapter 7 liquidation and receiving the then-present value of the collateral under the cramdown interest rate. At the point of cramdown, creditors will be exposed to a range of risk levels from

---

96. Id.
98. Id at 253.
99. One might go so far as to argue that the equity concerns espoused in favor of a case-by-case decision process are misplaced since the cramdown rate rule should not be concerned with equity to the particular creditor in cramdown but with the behavior of the population of creditors pre-bankruptcy.
debtors. Ex ante, it should be very difficult for a creditor to predict whether, if it enters bankruptcy, the debtor will be a high risk or low risk debtor at the cramdown stage. This difficulty will increase with the time gap between the initial loan and the date of bankruptcy. If such an assessment is assumed to be impossible, the creditors' ex ante pricing of loans will be influenced by the average cramdown rate across all debtors. Since creditors cannot predict which "type" of debtor they are dealing with, they will not be able to correlate the particular cramdown rates they are likely to encounter. Even if the type of debtor were known, the creditor would have to identify a correlation between similar types of debtors and past cramdown rate decisions. Uncertainty as to the identity of the presiding bankruptcy judge, and thus her particular record in determining cramdown rates, will further complicate creditors' efforts to predict the likely cramdown rate they would receive in a future bankruptcy.

If creditors look to the general pool of cramdown rates and are unable to predict which will apply to them, their decisions will be driven by the average rate. If they are risk averse, they will also consider the variance of the rate. Thus the proposed fixed rate approach establishes a cramdown average which induces efficient behavior and ensures virtually no variance in the pool of cramdown rates.

Inasmuch as the cramdown provision is concerned with affecting ex ante creditor behavior, and assuming that creditors cannot accurately predict the result of their particular future bankruptcy proceeding, courts should focus on the net effect the pool of cramdown rates has on pre-bankruptcy creditors rather than the effect of a particular cramdown rate on a particular creditor. A fixed rate's total predictability would make it easier for creditors to price loans. There would also be savings in the bankruptcy process from a fixed rate since fact finding to determine a discretionary rate would be unnecessary.

B. CHOOSING A FIXED RATE

If the fixed rate rule is adopted, it is important to consider the optimal fixed rate. This rate should be chosen with an eye towards its effect on pre-bankruptcy debtor and creditor behavior. Creditors will charge a premium for the expected

100. This approach would allow for the possibility of some rare adjustments in the fixed cramdown rate.

101. Estimates of the average cost of bankruptcy proceedings vary widely. One study found that for personal bankruptcies the cost of bankruptcy represented about 20 percent of the debtor's assets. Nevine D. Baxter, Leverage, Risk of Ruin, and the Cost of Capital, 22 J Fin 395, 395-96 (1967). Another study found that for large railroad firms the cost of bankruptcy was 1 percent of the market value of the firm. Jerold B. Warner, Bankruptcy Costs: Some Evidence, 32 J Fin 337, 337 (1977). However, even at 1 percent for large firms, the costs of bankruptcy are quite large. Further, as Warner has noted, these estimates are only for the direct costs of bankruptcy and do not include indirect costs like lost sales, lost profits, and the possible inability of the firm to obtain credit or to issue securities except under especially onerous terms (see discussion of new loan approach in Section I above). Id at 340-41.
risk and cost of default or bankruptcy. Setting aside other costs of bankruptcy and under-security, any cramdown rate below the contract rate should increase the premium charged in proportion with the perceived risk of bankruptcy. Similarly, the premium would be reduced by any cramdown rate above the contract rate. The effect of a cramdown rate which is significantly below or above the average contract rate will be to raise or lower the pre-bankruptcy rate charged. Since such a premium would be proportional to the perceived risk of bankruptcy, this effect would be magnified for high risk debtors.

The costs of bankruptcy and of inefficient investment are both a net loss for the market. The difficulty here is balancing these two costs. If a cramdown rate is set too low, it will result in higher interest rates, which will stifle efficient projects and send more debtors into bankruptcy. Creditors will seek a high pre-bankruptcy premium in an effort to “siphon” out bankruptcy costs, and perhaps some security interest, in advance of bankruptcy. In a sense, the creditor is preempting the bankruptcy process and may ironically drive a borderline debtor into bankruptcy. This suggests setting a high cramdown rate to prevent such preemptive behavior by guaranteeing lower bankruptcy losses to creditors. However, if cramdown rates are set too high, many more reorganizations will fail and end in bankruptcy, thus thwarting the primary goal of chapter 11. In fact, a high fixed cramdown rate may even preempt an attempt at reorganization by triggering the feasibility requirement of the Code.102 Under this section, a plan cannot be confirmed if it is likely to be followed by a liquidation or the need for further financial reorganization.103 In the most general terms, the foregoing suggests that a fixed rate approximating the average secured debt contract rate would induce the most efficient behavior in pre-bankruptcy creditors.

The cramdown rate also affects the decision to enter into bankruptcy. The higher the rate, the greater the incentive for creditors to apply for involuntary bankruptcy since the threat reorganization is only significant if the cramdown rate is low. Conversely, the lower the cramdown rate, the greater the incentive for debtors to seek chapter 11 reorganization relief. Bankruptcy proceedings are, in and of themselves, a net cost to the market. To the extent that they can be avoided by pre-bankruptcy workouts,104 such behavior should therefore be encouraged. In In re Colonial Ford, the court noted that several sections of the Code, including §305(a)(1), reflect this policy favoring workouts.105 Since the hurdles to creditors seeking involuntary bankruptcy are far higher than to debtors seeking chapter 11 protection, the effect the cramdown rate has upon debtors is more important. This suggests that the cramdown rate should be adjusted slightly upward to remove any additional incentive for debtors to enter bankruptcy and take advantage of the low cramdown rate. While the creditor effect does not vanish, it is at least somewhat overshadowed by the debtor effect.

102. 11 USC § 1129(a)(10).
103. Id.
104. Workouts are defined as “private, negotiated adjustments of creditor-company relations.” In re Colonial Ford, 24 Bankr 1014, 1015 (Bankr D Utah 1982).
105. Id.
This result is bolstered by the possibility of a lengthy cramdown proceeding, which has a greater negative effect upon the creditor.\textsuperscript{106}

The preceding discussion suggests that a fixed rate somewhat above either a market average contract rate or the particular contract rate would be an optimal balance of the dual goals of inducing efficient investment and minimizing bankruptcy costs. However, such a fixed rate would itself be susceptible to interest rate risk. Over time, the market average contract rate can change radically based on changes in the credit market and the real interest rate. Thus a truly fixed rate "magical number" would likely become stale fairly quickly. For example, the real interest rate moved in an 11.58 percent range between -3.44 percent and 8.14 percent in the decade between 1974 and 1984.\textsuperscript{107} If we presume that creditors can price the risk of changes in the interest rate ex ante, then such a fixed rate may be an effective rule.\textsuperscript{108} This presumption is reasonable, since just as creditors are in the business of assessing the creditor-worthiness and bankruptcy risk of debtors, they are also in the business of pricing such risk in the context of changing market interest rates. Thus a fixed rate which makes the cramdown rate equal to the contract rate plus some small premium should provide an effective and predictable rule.

However, one might argue that while the creditor did contract to accept interest rate risk for the term of the contract, she did not contract to accept it for the potentially longer term of payment in a reorganization plan or under the changed circumstances of the reorganization. This argument suggests a fixed rate with a variable portion to remove the interest rate risk. Such a rate would be similar to the formula approach taken by some courts,\textsuperscript{109} with a foundation of some standard rate (prime, treasury, etc.) and some additional factor. However, unlike the formula approach, under a fixed approach the additional factor would be a fixed premium or discount, rather than a discretionary premium determined by the judge or by common judicial practice, as is the case for the 2 percent standard. Thus, while less predictable than a true fixed rate, an interest-sensitive fixed rate would only move with market interest rates. Since creditors are able to price variable rate loans, presumably they can also price the risk of having a variable rate loan based on a standard market interest rate.\textsuperscript{110}

Some courts have in effect adopted such an interest-sensitive fixed rate by

\begin{flushright}
106. In his analysis of the effect of delay on criminal and civil cases, William Landes found that such delay reduces the prosecutor/plaintiff's minimum sentence/settlement offer while it has a dual and offsetting effect upon the defendant. William M. Landes, \textit{An Economic Analysis of the Courts}, 14 J L & Econ 61, 102 (1971).


108. One advantage of using the particular contract interest rate is that since variable rate contracts effectively self-correct for changes in interest rates, the interest rate risk is eliminated for this population of contracts.

109. See text accompanying notes 44-56.

110. Note that under the formula approach, the creditor is faced with the challenge of pricing the discretionary risk factor that the court assigns.
\end{flushright}
always choosing 2 percent for their risk factor. However, while an interest-sensitive fixed rate is certainly more predictable than a purely discretionary rate, a true fixed rate based on the particular contract rate is more perfectly predictable. Such a rate leaves the task of pricing the risks and costs of cramdown to the parties who are most concerned with such pricing, and best suited to do so.

C. POTENTIAL PITFALLS OF A FIXED CRAMDOWN RATE

While there is a strong argument for the adoption of a fixed rate rule, there are certainly pitfalls to this approach. Such a rule removes the cramdown rate as an informal policy tool in the hands of the judiciary. There are several reasons why a judge may reasonably seek an informal wealth transfer between parties through the cramdown rate. The judge may find that the net interests of society in achieving, or blocking, a reorganization override the interests of a party. However, the judge may be able to meet this goal through her fairly wide general discretion to approve or reject reorganization plans. The judge may also use the cramdown rate to address inequities between the parties. Such inequities might stem from market inefficiencies or behavior of the parties which violates the intent of the law but does not trigger a legal remedy.

A fixed rate rule also clearly rests on the presumption that parties are fairly effective at pricing such a rate ex ante. If the parties are unable to adjust their negotiations and agreements ex ante, we cannot presume that the fixed rate is either equitable or efficient.

Another potential problem with a fixed rate rule is the effect it may have on the credit markets as they adjust to a systematic change in the “rules of the game.” Presumably, any fixed cramdown rate which is lower than the average historical cramdown rate, should cause interest rates on relevant debt or required collateral levels to rise, leading to a tightening of credit as marginal debtors are squeezed out. Similarly, a fixed cramdown rate which is higher than the average historical rate should cause a decrease in interest rates or collateral demanded and a corresponding loosening of credit. At the same time, a higher cramdown rate will likely reduce the success rate for reorganizations, just as a lower rate will likely increase the success rate.

While a radical difference between a fixed rate and the historical rate might have some effect on the credit markets, it is important to note that the effect of any cramdown rate rule will be discounted by the likelihood of cramdown. Since presumably only a tiny fraction of all credit agreements result in a cramdown upon the creditor, the shift to a new fixed cramdown rate should only have a marginal affect upon pre-bankruptcy credit agreements. For example, if we posit a fixed rate rule with a 4 percent deviation from the historical cramdown rate, and we presume that 1 percent of all credit agreements result in a cramdown, the

111. See text accompanying notes 69-70.
112. Such inefficiencies might include the ability of some creditors to extract oligopoly or monopoly rates directly or indirectly from debtors. See text accompanying note 68.
establishment of this fixed rate rule should create a 0.04 percent shift in credit market rates. There is also a question of equity during the transition to a fixed rate rule for those parties who have already contracted under the old discretionary regime. In effect, one party or the other will suffer a loss, depending upon whether the fixed rate is above or below the historical cramdown rate. However, such effects can be significantly lessened by creating a grandfather clause or similar delay structure. This will allow the new cramdown rate to only apply to those contracts made after its adoption.

Thus, if one goal of any legislative or judicial fixed rate is to avoid a systemic effect upon the credit markets, we are constrained to choosing a fixed rate at or about the average historical cramdown rate. This does not remove the option of choosing an interest rate-sensitive cramdown rate. Over time, this rate may shift away from the initial rate, but it will only simulate changes in the credit markets since it will mirror the effect of the underlying real shift in interest rates.

Given the indirect and imperfect transitive effects of the cramdown rate upon ex ante creditor and debtor decisionmaking, as well as the secondary costs of an unstable credit market, there is a strong argument against using the cramdown rate as a policy tool to manipulate credit markets and, for instance, the flow of credit to high risk debtors.

**IV. Conclusion**

The choice of a cramdown regime should be driven by the goals of eliminating costs in the bankruptcy process and harnessing the efficiency of the market and its ability to price risk. This can be done by making the costs and risks of cramdown as predictable, and thus “priceable” as possible. In turn this suggests that some form of uniform fixed cramdown rate may be not only feasible but also preferable. An interest rate-sensitive rate based on some standard interest rate measure, and a fixed premium chosen to create a net cramdown rate equal to the recent historical average cramdown rate, would provide the best basis for a shift to a fixed rate regime. However, even more critical than the choice of the particular fixed rate is the importance of establishing some highly predictable and uniform cramdown rate regime from which creditors and debtors can most effectively price ex ante the costs and risks of bankruptcy. This approach is supported by the efforts of some circuits, through the formula approach, to develop uniform fixed rate regimes. However, it is unlikely that a uniform rule will emerge across all circuits. The creation of such a rule is better left to Congress.

113. While I will not undertake a calculation of the recent historical average cramdown rate, in those jurisdictions where the formula approach has been embraced, prime plus 2 percent is likely a good approximation of the average.