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CRAMDOWN AND THE CODE: CALCULATING CRAMDOWN INTEREST RATES UNDER THE BANKRUPTCY CODE

BY

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I. INTRODUCTION

Under section 1129(a)(9)(C) of the Bankruptcy Code ("Code"), when an entity reorganizes, authorities holding priority tax claims are entitled to receive over a six year period "deferred cash payments . . . of a value . . . equal to the allowed amount of such claim."¹ Section 1129(a)(9)(C) contemplates for tax claims a "cramdown" procedure similar² to that provided in sections 1129(b)(2)(A)(i)(II) for chapter 11 reorganizations,³ 1225(a)(5)(B)(ii) for family farms,⁴ and 1325(a)(5)(B)(ii) for wage-earners.⁵ Cramdown becomes necessary for the approval of a plan when a debtor asks the court to "cram the plan down the . . . throats" of creditors who will not consent to the plan.⁶

1. Section 1129(a)(9)(C) reads in entirety:

With respect to a claim of a kind specified in section 507(a)(7) [priority claims for taxes], the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

11 U.S.C. § 1129(a)(9)(C).

2. For the cramdown of secured claims there is an additional requirement that the secured creditor retain its lien on the collateral. *See, e.g., Id.* §§ 1129(b)(2)(A)(i)(I), 1225(a)(5)(B)(i), 1325(a)(5)(B)(i). Section 1129(a)(9)(C) also requires that priority tax claims be paid within six years, while the other cramdown provisions provide no limit on the length of repayment. These distinctions are irrelevant to the discussion in this paper.

3. *See, e.g., Id.* §§ 1129(b)(2)(A)(i)(II), 1225(a)(5)(B)(ii), 1325(a)(5)(ii). Section 1129(b)(2)(A)(i)(II) provides for the cramdown of secured claims:

that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property

Id. § 1129(b)(2)(A)(i)(II).

4. Section 1225(a)(5)(B)(ii) provides that with respect to each allowed secured claim provided for by the plan:

the value, as of the effective date of the plan, of property to be distributed by the trustee or the debtor under the plan on account of such claim is not less than the allowed amount of such claim

Id. § 1225(a)(5)(B)(ii).

5. Section 1325(a)(5)(B)(ii) is materially identical to section 1225(a)(5)(B)(ii), and provides that with respect to each allowed secured claim provided for by the plan:

the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim

Id. § 1325(a)(5)(B)(ii).

6. Aaron J. Bell, Comment, *Making Cramdown Palatable: Post-Confirmation Interest on Secured Claims In a Chapter 11 Cramdown*, 23 WILLAMETTE L. REV. 405, 406 (1987).

The cramdown provisions of the Code seek to balance the interest in allowing the debtor a "fresh start" with the protection of the secured creditors' loan.⁷

The cramdown of a secured creditor's claim raises two basic issues. First, the value of the claim must be established. Second, after establishing the value of the claim, the court must calculate the interest rate on the deferred cash payments that will protect the present value of the claim. The first step is conceptual: Determining how much the debtor owes to the creditor. The second step is administrative: Determining the best way to measure the value of the claim once established. Because the administrative step has been discussed at length elsewhere,⁸ this article deals with only the first issue.

Establishing the value of the claim raises the threshold questions of defining what the claim is. The claim may be either the secured creditor's claim to the value of the loan, or to the collateral securing the loan. This distinction raises the further issue of whether the appropriate cramdown interest rate should reflect the debtor or the creditor's cost of obtaining funds. As one court has observed, divining the cramdown interest rate requires the selection of "the relevant investor and the relevant market."⁹

Section II discusses consistencies in the application of the various cramdown provisions of the Code. It demonstrates the universal recognition that some "market" rate of interest should be used to establish the value of the creditor's claim, rather than a rate established by legislation. Section III discusses the sparse legislative history surrounding the cramdown provisions, finding it to be less than dispositive as to how the rate should be calculated. Section IV describes the traditional "new loan" approach used to calculate the interest rate. Section V describes an alternative approach, the "cost of funds," or "time value of money" approach. Whereas the new loan approach focuses on the interest rate that the creditor would charge the debtor for a hypothetical loan with the borrower's characteristics, the cost of funds approach focuses on the rate that the creditor would have to borrow to replace the funds foregone by the inability to foreclose and resell the collateral. Section VI compares the two approaches, and argues that only the new loan approach is consistent with sensible public policy. Section VII concludes.

7. *Id.*

8. See, e.g., James F. DesMarais, Note, *The Proper Discount Rate Under the Chapter 11 Cramdown Provision: Should Secured Creditors Retain Their State Law Entitlements?*, 72 VA. L. REV. 1499 (1986).

9. *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 66 (3rd Cir. 1993).

II. CRAMDOWN AND MARKET INTEREST RATES

The cramdown provisions of the Code guarantee a creditor deferred cash payments equal to the value of its claim. A consensus has developed that the interest rate to be used to guarantee a creditor the full present value of its claim should be a market rate of interest, as opposed to a statutorily-established rate.

Some early cases relied on the Internal Revenue Service judgment rate as established by section 6621 of the Internal Revenue Code¹⁰ as the cramdown interest rate.¹¹ Cases invoking section 6621, however, used it only as a proxy for the market rate of interest because of its accuracy and administrative simplicity,¹² or as a default rule when no other method was suggested.¹³ In each case the section 6621 rate was merely being used as a proxy for the market rate. As the Eighth Circuit concluded, "Courts considering this issue . . . have uniformly adopted the market rate approach. . . ."¹⁴

Other early efforts to calculate cramdown discount rates have also been abandoned. Early cases used state statutory judgment rates,¹⁵ the Federal Civil Judgment Rate,¹⁶ or the fifty-two week treasury bill rate.¹⁷ In each case, the proposed measurement has been replaced by a market rate. The values given by the alternative rates are *historical* measurements, based on rates in the past. Thus, it "may have little or no relationship" to the market rate of interest prevailing at the time of confirmation of the plan.¹⁸ Further, statutory rates may seek to

10. 26 U.S.C. § 6621.

11. See, e.g., *In re Ziegler*, 6 B.R. 3 (Bankr. S.D. Ohio 1980); *In re Hathaway, Coffee House, Inc.* 24 B.R. 534, 536 (Bankr. S.D. Ohio 1982); *In re Nite Lite Inns*, 17 B.R. 367, 373 (Bankr. S.D. Cal. 1982).

12. See *United States v. Neal Pharmacal Co.*, 789 F.2d 1283, 1289 (8th Cir. 1986) (section 6621 rate relevant for calculation of market rate); *In re Fi-Hi Pizza, Inc.*, 40 B.R. 258, 272 (Bankr. D. Mass. 1984); *Ziegler*, 6 B.R. at 6 (adopting section 6621 rate because it was "reasonably responsive to current economic conditions, [was] subject to periodic revision, yet [was] not an unfair burden on debtors").

13. See *Hathaway*, 24 B.R. at 536; *Nite Lite Inns*, 17 B.R. at 373.

14. *Neal Pharmacal*, 789 F.2d at 1285-86.

15. See *In re Johnson*, 44 B.R. 667 (Bankr. W.D. Mo. 1984) (legal judgment rate designed to compensate creditors for the deprivation of a possessory interest in property); *In re Marx*, 11 B.R. 819 (Bankr. S.D. Ohio 1981) (Chapter 13 case analogizing amounts in arrears on a home mortgage to confession of judgment fiction); *In re Crockett*, 3 B.R. 365, 368 (Bankr. N.D. Ill. 1980) (using legal rate as a proxy for market rate).

16. 28 U.S.C. § 1961. See *In re Tacoma Recycling, Inc.*, 23 B.R. 547, 550 (Bankr. W.D. Wash. 1982) (adopting section 1961 rate because of its ease of calculation and its frequent adjustment).

17. See *In re Frost*, 47 B.R. 961 (D. Kan. 1985); *In re Mitchell*, 39 B.R. 696 (Bankr. D. Or. 1984); *In re Connecticut Aerosols, Inc.*, 31 B.R. 883 (Bankr. D. Conn. 1983).

18. Chaim J. Fortgang and Thomas Moers Mayer, *Valuation in Bankruptcy*, 32 U.C.L.A. L. REV. 1061, 1119 (1985).

further objectives other than providing accurate market measurements,¹⁹ and short-term rates may not reflect future inflation expectations.²⁰ Thus, it has been remarked that courts “almost uniformly” agree with the use of a market rate of interest as of the effective date of the plan as the correct measurement of the cramdown interest rate.²¹

Although it is uniformly recognized that the market rate of interest is the appropriate theoretical measurement, “[u]nanimity disappears upon application.”²² Indeed, it has been observed that, “Few bankruptcy issues have met with as much confusion as the determination of a proper discount rate.”²³ Thus, it is not surprising that “the courts have not developed a uniform method of determining what the appropriate present value discount rate should be.”²⁴

The remainder of this article examines two competing theoretical visions of the proper measurement of the cramdown interest rate, and provides reasons for choosing between them.

III. BACKGROUND AND LEGISLATIVE HISTORY

Because the language and function of the various cramdown provisions under the Code are similar,²⁵ courts have generally used the precedents and techniques of the sections interchangeably.²⁶ This section examines the language and legislative history of the cramdown provisions to see if they indicate the proper approach.

19. See *In re Jordan*, 130 B.R. 185, 191 (Bankr. D. N.J. 1991).

20. See *In re Oaks Partners, Ltd.*, 135 B.R. 440 (Bankr. N.D. Ga. 1991).

21. *In re Mellema*, 124 B.R. 103 (Bankr. D. Colo. 1991); see also *In re Hardzog*, 901 F.2d 858, 859 (10th Cir. 1990); *United States v. Arnold*, 878 F.2d 925, 929 (6th Cir. 1989); *Matter of Southern States Motor Inns, Inc.*, 709 F.2d 647, 651 (11th Cir. 1983); *In re Underwood*, 87 B.R. 594, 599 (Bankr. D. Neb. 1988).

22. *In re Hardzog*, 901 F.2d at 859; *In re Camino Real Landscape Maintenance Contractors*, 818 F.2d 1503, 1505 (9th Cir. 1987); *Matter of Southern States Motor Inns, Inc.*, 709 F.2d at 651; *In re Underwood*, 87 B.R. at 599.

23. Fortgang and Mayer, *supra* note 18, at 1119.

24. C. Frank Carbiener, *Present Value in Bankruptcy: The Search for an Appropriate Cramdown Discount Rate*, 32 S.D. L. REV. 42 (1987); see also 5 COLLIER ON BANKRUPTCY, par. 1225.03, p. 1225-23 (Lawrence P. King ed., 15th ed. 1993) [hereinafter *Collier*].

25. See discussion at *supra* notes 1-7 and accompanying text.

26. See *In re Shannon*, 100 B.R. 913, 934 (S.D. Ohio 1989) (“The Court assumes that Congress intended this phrase to have a single meaning wherever used.”); *In re Snider Farms, Inc.*, 83 B.R. 977, 986 (Bankr. N.D. Ind. 1988). See also *Collier*, *supra* note 24, par. 1225.03, pp. 1225-22-23. But see *In re 222 Liberty Assocs.*, 108 B.R. 971, 995 n.16 (Bankr. E.D. Pa. 1990) (suggesting that it might be appropriate to favor consumer debtors when applying 11 U.S.C. § 1325(a)(5)(B)(ii), as compared to applying 11 U.S.C. § 1129(a)(2)(A)(i)(II) for commercial debtors).

A. Statutory Language

To confirm a plan, either: (1) the secured creditor must either accept or be unimpaired by the plan;²⁷ or, (2) if the secured creditor objects, the plan must not unfairly discriminate and must be fair and equitable.²⁸ For a plan to be "fair and equitable," the dissenting creditor must receive property of a value equal to the allowed amount of its secured claim.²⁹ Section 506(a) fixes the value of the secured creditor's claim, limiting it to the value of the security.³⁰ The cramdown plan must protect the creditor's interest in this secured claim.

The language of the cramdown provisions in the Code does not explain how to calculate the appropriate cramdown interest rate. As one commentator observes:

Conspicuous by its absence is any mention of a method to determine the appropriate discount rate. It is not even possible to say whether the statutory text favors the coerced loan approach or the time value of money approach. . . . Accordingly, the Court cannot ascertain the proper method of calculating the discount rate from a simple examination of the plain language of the statute, nor does the statute even indicate which of the two broad approaches, the coerced loan theory or the time value theory, is appropriate.³¹

Thus, although the expression "value, as of the effective date of the plan" appears repeatedly in section 1129,³² "in none of these instances does the statute mention a preferred method for ascertaining discount rates."³³

B. Legislative History

The legislative history accompanying the cramdown provisions of the Code also is not dispositive of how the secured claim should be calculated.³⁴ The House Report accompanying section 1129(b)(2) states that the section "contemplates a present value analysis that will discount

27. 11 U.S.C. § 1129(a)(8).

28. *Id.* § 1129(b)(1).

29. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 413 (1977) (Chapter 11); *Id.* at 430 (Chapter 13).

30. 11 U.S.C. § 506(a). Section 506(a) provides in relevant part, "An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property" *Id.* See also *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372 (1988).

31. *In re Shannon*, 100 B.R. 913, 933 (S.D. Ohio 1989).

32. See, e.g., 11 U.S.C. §§ 1129(a)(7)(A)(ii), (a)(7)(B), (a)(9)(B)(i), (a)(9)(C), (b)(2)(A)(i)(II), (b)(2)(B)(i), (b)(2)(C)(i), (b)(2)(C)(i).

33. *In re Shannon*, 100 B.R. at 935. See also *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 66 (3rd Cir. 1993) (noting that "the statute is silent about how to determine the interest rate").

34. See *In re Shannon*, 100 B.R. 913, 933 (S.D. Ohio 1989) ("Unfortunately, the

value to be received in the future. . . ."³⁵ "Present value is not necessarily a legal concept, but rather a term of art used by the economic and financial communities."³⁶

The legislative history describes in detail the mechanical process by which present value is calculated through the application of a specified discount rate. While this information is helpful once the appropriate interest rate is known, it provides no instruction on choosing that rate. As *Collier* observes:

The concept of "present value" does not define, and thus the court must determine, based on the facts of a given case, the appropriate "market rate" which will serve as the measuring standard by which the court can determine whether deferred payments under the terms of the plan have a value as of the effective date of the plan equal to the allowed claim.³⁷

Collier goes on to observe that "[w]hile the House Report is helpful in describing the operation of the discounting process, it is not particularly helpful in assisting the courts in determining what constitutes an appropriate discount rate."³⁸ As observed in *Shannon*, "the legislative history of section 1129 contains no endorsement which might indicate the proper method of setting discount rates."³⁹ None of the other cramdown sections contain any legislative history explaining how the "market rate" of interest is to be determined.

Some courts have declared that the legislative history unambiguously favors the new loan approach. This view is subject to two criticisms. First, it is not clear to what extent legislative history should be relied upon. Second, if relevant, it simply is not accurate to describe the legislative history as unambiguous in the cramdown context.

The Supreme Court has established a hierarchy of sources to rely upon in discerning the meaning of terms in the Code. First, where the language of the statute is clear, the interpreter is to implement this "plain meaning" and not look to other sources.⁴⁰ Second, the Supreme

legislative history of section 1225 contains no express manifestation of an intended method of generating discount rates The legislative pronouncements and reports concerning [section 1325(a)(5)(B)(ii)] are also devoid of an express preference for a certain method.").

35. H.R. Rep. No. 595, 95th Cong., 1st. Sess. 414 (1977).

36. *In re Snider Farms, Inc.*, 83 B.R. 977, 988 (Bankr. N.D. Ind. 1988).

37. *Collier*, *supra* note 24, par. 1129.03, p. 1129-83.

38. *Id.*, par. 1129.03, p. 1129-85.

39. *In re Shannon*, 100 B.R. 913, 935 (S.D. Ohio 1989).

40. *See* *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242 (1989). *But cf.* *Dewsnup v. Timm*, 112 S. Ct. 773 (1992). For a consequentialist justification of relying on textualism to interpret the bankruptcy code, *see* Robert F. Rasmussen, *A Study of the Costs and Benefits of Textualism: The Supreme Court's Bankruptcy Cases*, 71 Wash. U. L.Q. 535 (1993).

Court has suggested that the term be evaluated within the context of the Code itself, or, where possible, in the context of the specific section or subsection from which the term is drawn.⁴¹ Only if these sources are unavailing should the interpreter turn to the legislative history.⁴²

The meaning of the cramdown provisions cannot be settled by the face of the Code alone. But, as will be discussed,⁴³ the cramdown provisions take on a more precise, although still not definitive, meaning when examined in context.

Even if the language and structure of the cramdown provisions are unable to provide meaning to the terms of the Code, the sparse legislative history will certainly be unable to crack the riddle. Not only is the legislative history thin, but it is also vague. Nowhere in the legislative history is the term "claim" defined with regard to the cramdown of secured creditors. In particular, there is no indication whether the secured creditor's claim should be defined with reference to the loan or, instead, to the collateral securing the loan. Failing to generate an answer to this threshold question, judicial reliance on avowed legislative history devolves into little more than *ipse dixit*.⁴⁴

Further, the legislative history tends to link its discussion of present value with suggestions that it is concerned primarily with the time value of money.⁴⁵ This suggests that the creditor's claim for interest payments derives from its forced delay in receiving the property, not from the various elements that comprise a new loan, such as new risks unique to the debtor, administrative costs, and new market-wide risks (such as changed inflation expectations). Despite the distinction between the elements of a new loan and a pure time value of money approach, commentators persist in using the two interchangeably. Indeed, the phrase "time value of money" is often cited as corroborating holdings favoring the new loan approach.⁴⁶ Such imprecision in the use of

41. See *United States Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) ("Statutory construction . . . is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme — because the same terminology is used elsewhere in a context that makes its meaning clear.").

42. See *id.* at 380 (questioning whether the legislative history "is at all relevant" where the meaning of a term is clear from the four corners of the statute).

43. See *infra* notes 90-96 and accompanying text.

44. See, e.g., *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1505 (9th Cir. 1987), where the court draws upon remarks suggesting that "present value" analysis is appropriate, to conclude that the new loan approach is required. While the new loan approach is a reasonable reading of the present value requirement, it is certainly not the only reasonable reading. Indeed, until the question, "Present value of what?" is answered, there is no determinative reading of the present value requirement.

45. See, e.g., H.R. Rep. No. 595, 95th Cong., 1st Sess., at 412 (1977).

46. See, e.g., *In re Southern States Motor Inns, Inc.*, 709 F.2d 647, 651 (11th Cir. 1983), where the court cites *In re Busman*, 5 B.R. 332, 341 (Bank. E.D.N.Y. 1980), as support for

language may lead courts to find unwarranted certainty in the legislative history.

There is strong support for the proposition that when the legislative history speaks of “present value” it is using the term interchangeably with the new loan approach. Nonetheless, the legislative history is not so unambiguous as to render the cost of funds reading unreasonable. To decide between the two readings of the cramdown provisions requires further investigation into the structure and purposes of the Code and cramdown itself.

IV. THE NEW LOAN APPROACH

A. *The New Loan Approach Defined*

Most courts have treated cramdown as if it required “the creditor to make a new loan in the amount of the value of the collateral rather than repossess it, and the creditor is entitled to interest on his loan.”⁴⁷ Thus, courts have held that “the debtor must pay the [creditor] interest at the rate the debtor would pay a commercial lender for a loan of equivalent amount and duration considering the risk of default and any security.”⁴⁸ This view echoes that of a leading treatise:

It is submitted that deferred payment of an obligation under a plan is a coerced loan and the rate of return with respect to such loan must correspond to the rate which would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral, and risk.⁴⁹

The “new loan” heuristic is based on the fiction that the creditor in a cramdown situation is being coerced into making a new loan to the debtor, secured by the same collateral as the initial loan. The “approval” and secured nature of the hypothetical loan are taken as

its holding that the new loan approach should apply. The phrase quoted in support of its holding, however, seems reminiscent of the time value of money approach: “[W]hen secured tax claim is to paid in installments pursuant to a Chapter 13 plan, the creditor ‘is entitled to a percentile interest factor, to protect the creditor from loss caused by its being paid over time.’”

47. *Memphis Bank and Trust Co. v. Whitman*, 692 F.2d 427, 429 (6th Cir. 1982); see also *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 67 (3rd Cir. 1993) (quoting *Memphis Bank*).

48. *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1504 (9th Cir. 1987).

49. *Collier*, *supra* note 24, par. 1129.03, p. 1129-83.

given, with only the appropriate interest rate and duration to be determined. The court's duty is to determine the features this hypothetical loan would possess if granted voluntarily, given the characteristics of the debtor, market conditions generally at the date of the plan, and alternative investment opportunities.⁵⁰

B. *The Present Value Requirement*

Courts advocating the new loan approach have relied mainly on the legislative history of the cramdown clauses, combined with the persuasive authority of *Collier's* views.⁵¹ As discussed in Section III, however, the legislative history is somewhat ambiguous on the topic of valuing the secured creditor's claim in a cramdown. Nonetheless, the technique contemplated by the new loan approach seems to be the logical reading of the legislative history.⁵² The requirement that the secured creditor retain its lien,⁵³ combined with the further requirement that it receive deferred cash payments calculated as "of the effective date of the plan,"⁵⁴ suggests that the cramdown is equivalent to a new secured loan entered into as of the date of the plan.⁵⁵ Further, it is notable that the bulk of authority has favored the new loan interpretation, despite failing to articulate strong theoretical support for the position.⁵⁶ Although characterized as "slender reed" on which to base a decision, *Shannon* describes the new loan approach as the "majority rule for setting discount rates," permitting a "weak inference" that this is the proper interpretation of the cramdown provision.⁵⁷ This unanimity of interpretation presents persuasive

50. For a list of the factors that compose the rate of interest on a loan, see the discussion *id.*, par. 1129.03, p. 1129-83 n.45.

51. See *supra* notes 34-39, 49 and accompanying text.

52. As will be discussed *infra* at Section VI, when compared with the cost of funds approach, the new loan approach represents a more coherent understanding of the present value requirement.

53. 11 U.S.C. § 1129(b)(2)(A)(i)(I).

54. *Id.* § 1129(b)(2)(A)(i)(II).

55. But note, as discussed at *infra* notes 97-102 and accompanying text, this common-sense reading of the statute essentially demands that the court calculate an interest rate on a loan that does not exist in the real world. See *In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991). The fictitious nature of the new loan theory is most pronounced in the cramdown of tax claims under section 1129(a)(9)(C), because "there is no 'market' for the type of involuntary loan involved in the case of deferred payments of federal taxes because the IRS is not in the business of lending money." *United States v. Neal Pharmacal Co.*, 789 F.2d 1283, 1286 (8th Cir. 1986).

56. See *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1505 (9th Cir. 1987).

57. *In re Shannon*, 100 B.R. 913, 935 (S.D. Ohio 1989).

authority for the intuitive correctness of the new loan reading, although it is certainly not “conclusive.”⁵⁸

The requirement that the cramdown plan provide the secured creditor with the present value of its claim logically suggests that the secured creditor be no worse off under the cramdown plan than if the debtor were liquidated and the secured creditor received the collateral securing the claim. Indeed, a reasonable secured creditor should be indifferent between the two scenarios.⁵⁹ The secured creditor should be at least no worse off under the cramdown scenario than it was prior to bankruptcy.⁶⁰ As the Ninth Circuit noted in *Camino Real*, adopting the creditor’s cost of funds as the applicable interest rate would leave the creditor worse off as a result of the cramdown. Under the cost of funds approach to section 1129(a)(9)(C):

[T]he government would incur an unconditional obligation to repay the money it was required to borrow [to replace the funds foregone from the debtor], and would receive in exchange only an inherently risky promise by the debtor to repay the same amount over the applicable time period at essentially the same rate paid by the government on its obligation. The government would be worse off as a result of the exchange. . . . There is no indication that Congress meant to subsidize debtors undergoing reorganization by making available to them the government’s own favorable rate of interest.⁶¹

In general, the Code tries to preserve in bankruptcy the substantive rights of parties as defined outside bankruptcy, such as by state law.⁶² Thus, debtors should not see bankruptcy as an opportunity to improve their positions relative to creditors. Setting the cramdown rate according to the creditor’s cost of funds, however, would permit debtors to use bankruptcy to improve their positions relative to the arms-length bargain entered into at the outset of the contract. Under the cost of funds approach, the hypothetical “loan” made at the time of cramdown would not reflect the full range of considerations that entered into the fixing of the initial interest rate. The logical reading of “present value”

58. *Id.*

59. See discussion at *infra* notes 129-30 as to why cramdown is nonetheless necessary even though the creditors are seemingly indifferent.

60. See Thomas H. Jackson and Robert E. Scott, *Symposium on the Law and Economics of Bargaining: On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors’ Bargain*, 75 VA. L. REV. 155, 155-56 (1989).

61. *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1506 (9th Cir. 1987).

62. See *Butner v. United States*, 440 U.S. 48, 55 (1979).

seems at the least to exclude the possibility of opportunism on the part of debtors that this scenario presents.⁶³

As a corollary, the cost of funds approach would permit debtors in bankruptcy to improve their positions as compared to debtors that remain solvent. If the debtor can survive bankruptcy with its residual claim intact,⁶⁴ then there may be an increased incentive to dump the firm into bankruptcy in order to decrease the interest paid to creditors.⁶⁵ Even if there is no tangible incentive to enter bankruptcy prematurely, there seems to be no coherent policy goal for providing debtors in bankruptcy with preferential interest rates relative to solvent borrowers.⁶⁶

In effect, courts favoring the new loan reading of the present value requirement see it as a substantive limit on the definition of an "allowable claim." In other words, the creditor's "claim" must be defined so as to preserve the present value of the loan. Present value, in this reading, cannot be defined apart from the purposes of the "allowed claim" language. The creditor's "claim" is equivalent, by definition, to the present value of its loan. Thus, when a secured creditor is crammed-down, it must receive the interest rate on a new loan to the debtor with similar characteristics.

V. COST OF FUNDS APPROACH

One notable alternative to the predominant new loan approach is the "cost of funds" approach.⁶⁷ Although a number of bankruptcy courts have adopted the cost of funds model, no circuit court has done so. The circuit courts that have considered the argument have rejected it, although their reasoning has been neither uniform nor wholly

63. Further deleterious systemic effects of the cost of funds approach are discussed *infra* at Section VI.

64. For instance, through the injection of "new value," where the exception is recognized. See *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939); *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co.*, 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681 (1994) (holding that new value exception survived enactment of Bankruptcy Code). Of course, the new value contributed would have to be less than the present value of the savings generated by the reduction in interest payments resulting from the cramdown of the secured creditor's claim. For example, if the interest rate before cramdown was twelve percent, and the cramdown rate was seven percent, then the debtor would receive the present value of that five percent "windfall" on the date of the plan. The present value of the five percent savings would have to be larger than the new value contributed for this scheme to work.

65. Subject to the limits of the "good faith" requirement. 11 U.S.C. §§ 1112(b), 1129(a)(3); *In re Albany Partners, Ltd.*, 749 F.2d 670 (11th Cir. 1984).

66. Indeed, as will be discussed *infra* at Section VI, the cost of funds approach will have other undesirable policy consequences.

67. See *In re Rivera*, 144 B.R. 614 (Bankr. D.P.R. 1992).

persuasive.⁶⁸ Nonetheless, the cost of funds approach is also consistent with the language and structure of the Code, and is not necessarily inconsistent with the legislative history.⁶⁹

A. *The Present Value Requirement*

The cost of funds model has its genesis in *Collier's* treatise on bankruptcy. In discussing chapters 11 and 12, *Collier* applies the new loan approach.⁷⁰ In its discussion of chapter 13 cramdown, however, the authors advocate the cost of funds approach.⁷¹ Under the cost of funds approach, the court sets the cramdown interest rate according to what it would cost the creditor to borrow to replace the funds not forthcoming from the debtor. Thus, the focus is on the *creditor's* interest rate for borrowing, not the debtor's rate. Because the creditor will frequently be a commercial bank or government entity, it usually will be able to borrow at a lower rate of interest than the debtor. As a result, applying the cost of funds rate will permit the debtor to use cramdown to decrease the interest rate it is paying on its loan.

Collier discusses the theory underlying the focus on the creditor's cost of funds:

The purpose of the present value requirement is to place the holder of an allowed secured claim in the same position economically as if the debtor exercised the option of surrendering the collateral. Through the payment of interest, the creditor is compensated for

68. See, e.g., *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 67 (3rd Cir. 1993) (rejecting cost of funds approach for chapter 11 cramdown as undercompensatory to creditor); *United Carolina Bank v. Hall*, 993 F.2d 1126, 1130 (4th Cir. 1993) (same); *In re Hardzog*, 901 F.2d 858, 860 (10th Cir. 1990) (rejecting cost of funds approach in chapter 12 cramdown due to administrative difficulties in application); *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1506 (9th Cir. 1987) (rejecting cost of funds approach in § 1129(a)(9)(C) cramdown as undercompensatory to creditor).

69. See discussion *supra* at Section III.

70. Curiously, however, *Collier* advocates different administrative techniques for calculating the cramdown of claims in the respective discussions. Regarding chapter 11, the authors propose the use of the "forced loan" approach, calling for the use of expert testimony to establish the cramdown interest rate. *Collier*, *supra* note 24, par. 1129.03, p. 1129-83. In discussing chapter 12, however, the authors advocate use of a "formula" approach, which establishes the cramdown rate by breaking the overall interest rate on a loan into its three constituent parts: a "riskless" rate, market risks (such as inflationary expectations), and risks unique to the particular debtor. *Id.*, par. 1225.03, pp. 1225-24-25. As will be discussed momentarily, however, such unexplained inconsistencies occur elsewhere in *Collier*.

71. See *Collier*, *supra* note 24, par. 1325.06, pp. 1325-45-48. This anomaly in *Collier* has been noted. See, e.g., *In re Ivey*, 147 B.R. 109, 116 (M.D.N.C. 1992); *In re Breisch*, 118 B.R. 271, 272 n.3 (Bankr. E.D. Pa. 1990); *In re Shannon*, 100 B.R. 913, 932 n.46 (S.D. Ohio 1989).

the delay in receiving the amount of the allowed secured claim, which would be received in full immediately upon confirmation if the collateral were liquidated. Since the creditor is deprived of these funds to the extent they are deferred through the plan, the creditor must obtain them elsewhere, for whatsoever purposes they were to be used. In view of this purpose, the 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.⁷²

Thus, the creditor is entitled to only the time value of money, with no compensation for the other factors that comprise the interest rate on a standard loan.

In the same chapter, *Collier* rejects the new loan approach to the cramdown interest rate:

Thus, contrary to the holdings of a number of courts, it is rarely appropriate to select the rate charged to the debtor in the original transaction as the present value discount rate. Treating the chapter 13 deferral of payments like a new loan transaction, as those courts have done, provides the holder of the allowed secured claim with not only the cost of funds it would lend but also the cost of a new loan transaction, which would not be incurred, and the profit that would be earned in that transaction. Neither of the latter two amounts would be received if the collateral were surrendered; the lender would have to incur new transaction costs to earn an additional profit. To include them in the present value discount rate would give the holder of an allowed secured claim more than the equivalent of payment of that claim in full.⁷³

Thus under the cost of funds approach, the cramdown interest rate should be set "equal to what it costs the creditor to replace the funds not forthcoming from the debtor."⁷⁴ Since the purpose of the Code's present value requirement is "to compensate creditors for not receiving the value of their claim on the date of confirmation, these courts set the discount rate equal to what it costs creditors to replace that value."⁷⁵ The creditor is entitled only to the time value of its money, not what it could receive in a hypothetical new loan to the debtor.

72. *Collier*, *supra* note 24, par. 1325.06, pp. 1325-45-46.

73. *Id.*, par. 1325.06, p. 1325-46.

74. Carbiener, *supra* note 24, at 54.

75. *Id.*

The cost of funds approach rejects the notion that the creditor's claim for purposes of calculating present value is equivalent to the value of the loan itself. Rather, the creditor is entitled to only the present value of the collateral upon which it is now unable to foreclose.⁷⁶ As the court wrote in *In re Hudock*, the "Bankruptcy Code protects the creditor's interest in the property, not in the creditor's interest in the profit it had hoped to make on the loan. . . . When, as here, the debtor is allowed to keep the collateral, the creditor has to borrow the funds that otherwise it would realize from selling the collateral. To protect the creditor's property interest, the discount rate should be comparable to its cost of borrowing."⁷⁷ Thus, the relevant interest rate is the actual cost to the secured creditor of being temporarily deprived of payment of its claim, and therefore having to borrow the sum elsewhere.⁷⁸

The cost of funds approach argues that two elements of the market rate charged in a typical loan transaction are illegitimate in a cramdown. First, transaction costs that would accompany a truly new loan. Second, is the "profit" said to be included in most loans.

Transaction costs excluded by the costs of funds approach includes administrative and collection costs. Administrative costs, such as the costs of borrower screening (i.e., loan officers' salaries and the cost of checking credit ratings), are excluded because the creditor has already extended the credit.⁷⁹ Similarly, courts have argued that collection costs are also eliminated or reduced "because the creditor has received a continuing judicial remedy which, upon default, allows the creditor to bypass much of the collection process."⁸⁰ Thus, the cramdown discount rate should not include the costs of pursuing delinquent borrowers, such as hiring a collection agency to collect bad debts.⁸¹

"Profit" from the loan is also impermissible.⁸² It is said that if the creditor "is authorized a rate greater than its borrowing costs, it is making a profit on the delay and will be receiving more than the present value of the collateral."⁸³ Protecting a creditor's profit "is

76. See *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 67 (3rd Cir. 1993).

77. *In re Hudock*, 124 B.R. 532, 534 (Bankr. N.D. Ill. 1991).

78. *In re Wilkinson*, 33 B.R. 933, 936 (Bankr. S.D.N.Y. 1983). See also *In re of Campbell*, 16 B.R. 496, 497 (Bankr. N.D. Ill. 1982); *In re Jordan*, 130 B.R. 185, 191 (Bankr. D.N.J. 1991).

79. See *In re Jordan*, 130 B.R. 185, 190 (Bankr. D.N.J. 1991); *In re Mitchell*, 39 B.R. 696 (Bankr. D. Or. 1984); *In re Connecticut Aerosols, Inc.*, 31 B.R. 883 (Bankr. D. Conn. 1983), *aff'd* 42 B.R. 706 (D. Conn. 1984); *In re Fisher*, 29 B.R. 542 (Bankr. D. Kan. 1983); *In re Johnson*, 8 B.R. 503 (Bankr. S.D. Tex. 1981).

80. Carbiener, *supra* note 24, at 61; *accord*, *In re Ivey*, 147 B.R. 109, 116 (M.D.N.C. 1992).

81. See *Mitchell*; *Connecticut Aerosols*; *Fisher*; *Johnson*.

82. See *In re Hardzog*, 113 B.R. 718, 721 (W.D. Okla. 1989), *rev'd* 901 F.2d 858 (10th Cir. 1990).

83. *In re Willis*, 6 B.R. 555, 563 (Bankr. N.D. Ill. 1980).

contrary to a basic tenant of bankruptcy law that the creditor's property, but not his profit, will be protected.⁸⁴ Further, because "any profit paid to secured creditors will not be available to satisfy unsecured obligations, allowing creditors to collect profit clearly violates the Code objective of treating all creditors fairly, and it should not be allowed."⁸⁵

As a corollary to the rejection of profit as a component of the cramdown interest rate, the cost of funds approach considers it improper to compensate the creditor for the opportunity cost of funds — i.e., the creditor's alternative uses for the funds tied-up in the loan to the debtor.⁸⁶ One court has commented that the cramdown interest rate "need not be geared to whether the arrangement is profitable for the creditor, merely whether it is getting the value of its collateral. The cost of money to the lender should be the principal determinant, not what the creditor might have been able to do with the money elsewhere."⁸⁷

Thus, with regards to the semantic argument over the meaning of the "present value" requirement in the legislative history, advocates of the cost of funds approach argue that the term "allowable claim" must be read distinctly from this present value requirement. Present value cannot be calculated until the secured creditor's claim is defined. The cost of funds approach sees the present-value requirement as essentially a procedural instruction for the mechanics of discounting a substantive claim defined independently from the present value requirement. The definition of the substantive claim is seen as severable from the mechanical requirement that the secured creditor receive the present value of this claim. The new loan approach, by contrast, sees the present value requirement as a substantive protection on the creditor's rights in cramdown.⁸⁸ The legislative history's emphasis on the mechanics of present value calculation, as compared to its relative silence regarding any substantive contours, suggests that the cost of funds approach is a plausible reading.⁸⁹

B. *The Structural Argument*

An argument for the applicability of the cost of funds approach can also be derived from the structure of the Code. When examined

84. *In re Ivey*, 147 B.R. 109, 116 (M.D.N.C. 1992).

85. Carbiener, *supra* note 24, at 60.

86. As discussed at *infra* notes 116-22 this view rests on the error that "profit" and opportunity cost can be conceptually distinguished from the interest rate for a loan.

87. *In re Benson*, 9 B.R. 854, 858 (Bankr. N.D. Ill. 1981).

88. *See* Landmark Financial Services v. Hall, 918 F.2d 1150, 1153-54 (4th Cir. 1990) (the dual requirements of lien retention and present value is intended to compensate secured creditors for "any modifications of their rights").

89. *See* discussion *supra* at Section III.

in the context of the cramdown subsection of the Code, an argument can be made that the present-value requirement is linked to the collateral securing the loan, not the entire value of the loan itself.

In chapters 12 and 13, the Code presents an option between either retaining the lien and receiving the present value of the claim; or, surrendering the property to the secured creditor.⁹⁰ In chapter 11, the Code supplies three options.⁹¹ First, the secured creditor can retain its lien and receive the present value of its claim.⁹² Second, the collateral may be sold, with the lien attaching to the proceeds from the sale.⁹³ Finally, the debtor can supply the creditor with the “indubitable equivalent” of its claims.⁹⁴ While the contours of the indubitable equivalence provision are uncertain,⁹⁵ surrendering the collateral to the secured creditor is unquestionably sufficient.⁹⁶

Thus, the practical alternatives are to surrender either the collateral or the proceeds from a sale of the collateral. Examined in context, it is sensible to argue that the “allowed claim” in the Code is concerned with the collateral securing the loan, not necessarily the loan itself. Thus, the focus of the cost of funds approach on the creditor’s right to the collateral, not the loan itself, seems facially plausible. Viewing cramdown as an alternative to surrendering or selling the collateral suggests that the secured creditor is entitled only to the value necessary to replace the foregone funds. This is the creditor’s cost of funds rate.

C. *The New Loan Approach is Unrealistic*

A final argument in favor of the cost of funds approach is the seeming illogicality of the new loan approach. The new loan approach requires not only the calculation of an interest rate on a purely hypothetical loan, but a hypothetical loan that has no real-world counterpart.⁹⁷ Unlike the new loan approach, “at least a market exists in the real world for loans to the creditor.”⁹⁸ As the bankruptcy court wrote in *Matter of Jordan*, “[I]t is difficult to arrive at a current market rate of interest for a hypothetical new loan when there is no market for the loan proposed, no equity in the property, and limited

90. 11 U.S.C. § 1225(a)(5), 1325(a)(5).

91. *Id.* § 1129(b)(2)(A).

92. *Id.* § 1129(b)(2)(A)(i).

93. *Id.* § 1129(b)(2)(A)(ii).

94. *Id.* § 1129(b)(2)(A)(iii).

95. See *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935).

96. See *Collier*, *supra* note 24, par. 1129.03, p. 1129-58.

97. *In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991).

98. *In re Ivey*, 147 B.R. 109, 117 (M.D.N.C. 1992).

opportunity on the part of the debtor to obtain financing outside of the Bankruptcy Code framework."⁹⁹ More generally, it is unlikely that any lender would voluntarily lend on a one-to-one loan to value ratio, as is the case in a cramdown forced loan.¹⁰⁰ If the creditor were to offer such a risky loan, it would demand such a high interest rate that the feasibility of the debtor's plan probably would be imperiled.¹⁰¹

Advocates of the cost of funds approach argue that reading the statute in this manner produces an absurd result. While the language of the statute is compatible with the new loan approach, it is argued that the application of the new loan principles generates an unreasonable outcome. The new loan approach seemingly requires the courts to "replicate" a hypothetical loan with no real-world counterpart. This seems to be an illogical reading of the statute. Further, it suggests that any result arrived at by such a process is likely to be little more than sheer speculation.¹⁰² In the light of the illogicality of the new loan reading, it is argued that the more realistic cost of funds approach must be correct.

VI. COMPARISON: WHY THE NEW LOAN APPROACH IS CORRECT

Textual, structural, and legislative history arguments are not dispositive of the whether the new loan or cost of funds approach is the proper method for determining the cramdown interest rate for secured claims.¹⁰³ On each footing, arguments can be made for either side. Nonetheless, it is not a mere toss-up as to which approach is required by the Code.

As noted in *Timbers of Inwood Forest*, "A provision that may seem ambiguous in isolation is often clarified . . . because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law. . . ."¹⁰⁴ As in *Timbers*, "[t]hat is the case here." This Section demonstrates first that when the structure of financial markets is considered, the cost of funds approach

99. *In re Jordan*, 130 B.R. 185, 189 (Bankr. D.N.J. 1991).

100. See *In re Wichmann*, 77 B.R. 718, 720 (Bankr. D. Neb. 1987).

101. *In re Ivey*, 147 B.R. 109, 115 (M.D.N.C. 1992); *In re River Village Assocs.*, 161 B.R. 127, 138 (Bankr. E.D. Pa. 1993); *In re Oaks Partners, Ltd.*, 135 B.R. 440, 445 (Bankr. N.D. Ga. 1991).

102. See *In re Computer Optics, Inc.*, 126 B.R. 664, 672 (Bankr. D.N.H. 1991). One court deems the attempt to establish the rate on a hypothetical loan to be "impossible and simply a waste of time." *Ivey*, 147 B.R. at 118.

103. See discussion *supra* at Section III.

104. *United Savs. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988).

undercompensates the secured creditor for its claim. Second, this undercompensation produces negative systemic consequences that render the cost of funds approach inappropriate for the cramdown discount rate. Only the new loan approach produces systemic effects “compatible with the rest” of the purposes of the Bankruptcy Code.

A. The Cost of Funds Rate is Undercompensatory

The cost of funds approach undercompensates the secured creditor for the cramdown of its secured claim. As a result, adoption of the cost of funds approach creates systemic problems that necessitate use of the new loan approach.

The cost of funds approach excludes transaction costs and “profit” from the calculation of the cramdown discount rate.¹⁰⁵ Denying compensation for these two elements of the interest rate will undercompensate the secured creditor in cramdown.

1. Transaction Costs

The cost of funds approach asserts that the creditor experiences lower transaction costs and a lower risk of default with a secured cramdown claim than with a similar new market loan.¹⁰⁶ It is doubtful, however, that there will be any net decrease in administrative costs when a secured claim becomes a cramdown claim in bankruptcy. While some administrative costs will already have been incurred, and thus saved, in making the “new loan,” the “legal, managerial, and clerical costs in monitoring and accounting” for a bankruptcy claim will at least offset these savings.¹⁰⁷

Using the cost of funds approach increases some administrative burdens as compared to using the new loan approach. The rates and terms available to borrowers for a standard loan are well-known and easily available to the public, through numerous financial reports and daily publications.¹⁰⁸ Determining the creditor’s cost of funds, on the other hand, requires detailed investigation of the creditor’s financial records.¹⁰⁹ And while the new loan approach is criticized for its

105. See discussion at *supra* notes 79-87 and accompanying text.

106. *In re Cassell*, 119 B.R. 89, 92 (W.D. Va. 1990).

107. *Id.*; see also *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 68-69 (3rd Cir. 1993).

108. See *In re Crane Automotive Inc.*, 88 B.R. 81, 85 (Bankr. W.D. Pa. 1988).

109. See *In re Snider Farms, Inc.*, 83 B.R. 977, 996 (Bankr. N.D. Ind. 1988) (“To make a ‘creditor specific’ analysis of the various components that make up the secured creditor’s interest rate such as cost of funds and profit will unduly complicate and burden the process of determining present value with protracted evidentiary hearings relating to the specific secured creditor’s loan policies. . .”).

seemingly speculative nature, the variety of factors that would necessarily enter into the cost of funds calculation would render it equally speculative. Attempting to parse illegitimate expenses for profit and transaction costs from legitimate expenses is a futile task.¹¹⁰

The cost of funds approach also posits that the risk of default is lower on a bankruptcy claim. It is argued that "the court has determined that the [reorganization] plan is feasible, the creditor retains the lien, and the creditor has the right to seek adequate protection at any time."¹¹¹ The characteristics of the property will be better known than in the typical market transaction because of the information-forcing nature of bankruptcy's adversary process, such as discovery, testimony under oath, and investigation by expert witnesses.¹¹² Finally, the property has an operating history on which to base future performance predictions.¹¹³

Other courts question the significance of these factors in reducing the risk of default, noting that "the issue of whether or not the risk of default is lessened is an empirical question upon which no evidence has been offered."¹¹⁴ Other factors will tend to increase the risk of a cramdown loan. For instance, the collateral for the original loan probably provided an equity cushion to protect against depreciation. Because the loan to value ratio for a cramdown loan is one to one, there is no equity cushion.¹¹⁵

Thus, the cost of funds approach is incorrect in attempting to exclude transaction costs from the cramdown discount rate. It is inappropriate because there is no evidence that there is any material decrease in administrative and default costs when a secured loan becomes a cramdown loan. Furthermore, attempting to distinguish legitimate from illegitimate expenses will increase other administrative costs and increase the speculative nature of the rate established.

110. See *In re Hardzog*, 901 F.2d 858, 860 (10th Cir. 1990), where the court describes the elements that comprise the "market rate" of interest:

A lender, in establishing interest rates to be charged to a borrower, will consider and utilize many factors, including what the competition charges, its cost of funds, the condition of the local economy, its overhead, the character of the borrower, the capacity of the borrower to repay, the value of the collateral, the cost of servicing the loan, the status of the lender's loan portfolio, the lender's ratio of loans to assets, its liquidity, and a host of other factors.

Id.

111. *Cassell*, 119 B.R. at 92.

112. *In re Bloomingdale Partners*, 155 B.R. 961, 983 (Bankr. N.D. Ill. 1993).

113. *Id.*

114. *Cassell*, 119 B.R. at 93; see also *GMAC v. Jones*, 999 F.2d at 69 (contending that "it would be difficult or impossible to empirically demonstrate and quantify the cost differential between new and coerced loans").

115. See *GMAC v. Jones*, 999 F.2d at 68.

2. Profit

The cost of funds approach also argues that “profit” should be excluded from the cramdown interest rate. The view that there is some element of the interest rate that is illegitimate “profit” misunderstands the nature of financial markets. As a result, excluding so-called profit from the cramdown interest rate will lead to undercompensation for secured creditors.

What is deemed “profit” is indistinguishable from the normal return on capital without which loans will not be made. “Profit” is actually the real interest component of the market rate, thus it “is properly considered part of the cost of capital.”¹¹⁶ Thus, “courts that reduce market rates by the ‘profit’ element are indirectly denying the creditor compensation for the court’s taking of the creditor’s current use of funds.”¹¹⁷

“Profit” is actually the cost of deferring present consumption until a later time, and the tradeoff within a creditor’s business between alternative methods of financing.¹¹⁸ Even if payment was guaranteed and inflationary expectations were zero, the real interest rate would still be positive, because it reflects “the price required to induce a lender to effect an exchange between current and future consumption.”¹¹⁹ Thus, there is no “profit” from enticing deferred compensation.

The so-called “profit” on a loan also represents the opportunity cost of the capital tied-up in the loan. A creditor faces the decision

116. *In re Cassell*, 119 B.R. 89, 92 (W.D. Va. 1990).

117. Waltraud S. Scott, *Deferred Cash Payments to Secured Creditors in Cram Down of Chapter 11 Plans: A Matter of Interest*, 63 WASH. L. REV. 1041, 1050 (1988).

118. “Profit” can only persist if there is some market inefficiency that permits the capturing of supra-market returns, or “rents,” for an extended period of time. Absent rent-preserving barriers to entry, any potential profits will be quickly dissipated and all parties will return to a normal rate of return. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.8, p. 121 (4th ed. 1992).

One commentator has argued that profits may persist in the context of consumer loans and chapter 13 cramdowns. It is argued that as a result of market inefficiencies, consumers fail to locate and secure the lowest rates available. *In re Cassell*, 119 B.R. 89, 92 (W.D. Va. 1990). It is said that inefficient transmission of information obstructs the identification of alternative borrowing opportunities; and, lack of sophistication and unequal bargaining power prevents obtaining competitive rates. As a result, it is argued, there is persistent monopoly power, permitting the long-range capture of rents.

This view is subject to two criticisms. First, as noted in *Cassell*, there is no empirical evidence that this model accurately describes the market for consumer loans. *Cassell*, 119 B.R. at 92. Second, if the model fails to describe the chapter 13 context accurately, then it must be completely lacking in predictive power for chapter 11 and 12 loans. Arrayed on spectrum, consumers would be likely to possess both less information and less sophistication than farming businesses or commercial debtors. Thus, the absence of long-term profits for consumer lenders excludes the possibility of such results for commercial lenders.

119. Scott, *supra* note 117, at 1047.

whether to finance its activities through equity or debt. The cost of funds approach "assumes that the proper measure of a creditor's cost of funds is its incremental borrowing cost."¹²⁰ When deciding whether to "meet its marginal funding needs through equity or through debt," the firm's "costs of capital for those needs is more properly reflected by its weighted average cost of capital rather than its marginal cost of capital."¹²¹

Opportunity cost reflects the fact that if the creditor was not forced to lend to this debtor, then it could lend those funds to a different borrower. This is the real cost of the inability to foreclose.¹²² If the creditor could foreclose, then it could relend the funds generated by the resale. Thus, the rate at which the creditor would borrow to replace the foregone collateral is irrelevant. All that matters is the alternative use of the capital that the debtor continues to use. If the money was not already locked-in to the debtor's use, the secured creditor could capture the market rate on a new loan. Thus, when compared to the opportunity cost of the loan to the debtor, there is no "profit" to be subtracted from the interest rate, because the interest rate is simply the price of the debtor's continuing use of the capital rather than some other use.

B. Systemic Effects

The Bankruptcy Code does not operate in a vacuum. To the extent that bankruptcy alters substantive rights determined outside of bankruptcy's collective forum, it will necessarily have an impact on the allocation of those non-bankruptcy rights. If bankruptcy imposes additional risks on one party or another through an ability to alter non-bankruptcy rights, the parties' behavior outside of bankruptcy will be changed. Because the cost of funds rate undercompensates secured creditors for the value of their claims, it will have undesirable systemic effects on pre-bankruptcy behavior.

120. *In re Cassell*, 119 B.R. 89 (W.D. Va. 1990).

121. *Id.*

122. Opportunity cost appears to be the thrust of the concern in *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63, 67 (3rd Cir. 1993), that the costs of the new loan in bankruptcy include "not only the cost of capital over the deferral period but also the cost of sustaining the lending relationship over that period." See also *United Carolina Bank v. Hall*, 993 F.2d 1126, 1130 (4th Cir. 1993) (because "every secured creditor has a limited amount of credit on which to draw, . . . it follows that utilizing some of that borrowing capacity without providing the secured creditor with the usual return on its capital produces a loss for the secured creditor").

The Code forbids *ipso facto* clauses.¹²³ As a result, parties will not be able to protect themselves against the specific risks incurred in bankruptcy resulting from the filing by specific debtors. Absent the prohibition on *ipso facto* clauses, lenders could contract with debtors to “undo” the reallocation of rights resulting from the bankruptcy proceeding. For example, if the bankruptcy rule improves the debtor’s position over the optimal allocation voluntarily bargained-for outside of bankruptcy, then the parties could contract to reallocate the rights awarded by bankruptcy back to the initial distribution. This would allow the parties to effectively “contract-around” an inefficient rule, thereby maintaining the optimal allocation of risks among the parties. Further, this would allow the parties to tailor the operation of the rights reallocation to the particular situations where it is most necessary, namely for borrowers who file for bankruptcy. Thus, if *ipso facto* clauses were valid, there would be no effect on behavior in the agreement upon the initial designation of rights.

Because of the invalidity of *ipso facto* clauses, however, the possibility of bankruptcy resulting in a reallocation of substantive rights will impact the initial bargaining over these rights. Because the parties will not be able to undo the ex post effects of bankruptcy, they will have to account for these increased risks ex ante. Because it is impossible to identify at the time of granting credit which borrowers are most likely to enter bankruptcy eventually, creditors will be unable to tailor their risk readjustments to the debtors who do, in fact, increase risk. As a result, they will have to alter their behavior towards debtors as a class. They will have to treat all debtors the same, regardless of their relative probabilities of entering bankruptcy.

If bankruptcy results in a transfer of risk from debtors to creditors, relative to the level arrived at in the initial arms-length bargain, then creditors will increase the interest rate charged to *all* debtors at the outset. Thus, any redistribution afforded debtors as a class as a result of the pro-debtor bankruptcy rule will be eliminated by the increased rate creditors will charge initially. The apparent pro-debtor effects of the bankruptcy rule will be eliminated by the increased interest rates charged to debtors as a class. At the same time, debtors who end up in bankruptcy will receive a windfall, as they will reap the rewards of the pro-debtor bankruptcy rule.

The situation described demonstrates the consequences that would follow from the adoption of the cost of funds approach to cramdown. It permits debtors to use bankruptcy to decrease the interest rates agreed upon outside bankruptcy by excluding “profit” and transaction costs.

123. See, e.g., 11 U.S.C. § 365(e)(1).

Thus, it is a substantive rule with pro-debtor effects. In the face of such a rule, creditors would increase the ex ante rate charged to all debtors to reflect the increased risk resulting from a cramdown that would provide them with an undercompensatory rate of interest. In turn, this higher initial rate of interest would undermine the success of borrowers generally, making it more likely at the margin that they will default. Although all borrowers will pay the price for the pro-debtor bankruptcy rule, only those that actually enter bankruptcy will be able to garner its benefits.

This tendency to redistribute wealth from good risks to poor risks creates an adverse selection, or "lemons," problem.¹²⁴ Because lenders cannot distinguish good risks from bad ex ante, and because good risks borrowers will subsidize bad risks, over time the credit market will come to be dominated by bad risk borrowers.¹²⁵ Good risks will abandon the market by substituting equity for credit, thereby upsetting the optimal balance between the two sources of capital. The purpose of offering secured credit — to decrease the interest rate a borrower would otherwise have to pay for unsecured credit — will be undermined. Thus, by undermining the efficiency of capital markets, a redistributive bankruptcy rule will hurt all borrowers as a class and reduce societal wealth.

This model may articulate the intuition underlying *Camino Real's* protest that the debtor should not be permitted to benefit from the creditor's (in that case, the government) preferential interest rate.¹²⁶ If the Ninth Circuit's complaint was simply that the cost of funds approach would redistribute wealth from the particular creditor in that case to the particular debtor, then there is little reason to prefer one rule to the other.¹²⁷ But, the Ninth Circuit overlooked the systemic result that the cost of funds rule would not just redistribute wealth between the creditor and debtor in that isolated case. Rather, by providing a

124. The term, as well as the concept, is discussed in George A. Akerlof, *The Market for 'Lemons': Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488-500 (1970).

125. This is an application of "Gresham's law": just as bad money will drive out good money when the exchange rate is even, bad risk borrowers will drive out good risk borrowers when the risk premium for "renegotiation" through bankruptcy is spread equally among all borrowers. See *id.* (applying Gresham's law analogy to the market for used cars).

126. *In re Camino Real Landscape Maintenance Contractors, Inc.*, 818 F.2d 1503, 1506 (9th Cir. 1987).

127. In *In re Hardzog*, 113 B.R. 718, 721 (W.D. Okla. 1989), *rev'd on other grounds*, 901 F.2d 858 (10th Cir. 1990), for instance, the bankruptcy court balanced the potential loss to the secured creditor from the exclusion of "profit" from its cramdown rate against other policy goals, including the "rehabilitative purposes of chapter 12," and protection of the estate against "inordinate[] [consumption]" resulting from high interest payments. Some commentators, however, believe that the redistribution of wealth in bankruptcy is *per se* invalid unless necessary to enlarge the size of the estate as a whole. See Jackson and Scott, *supra* note 60.

windfall for the debtor in that case, it would harm all future borrowers by forcing them to pay a higher pre-bankruptcy interest rate. This will push debtors into bankruptcy prematurely. In light of these undesirable systemic consequences, the cost of funds approach must be rejected.

C. Cramdown and The Code

It is widely accepted that an overarching purpose of the Bankruptcy Code is to provide a collective debt collection proceeding in order to overcome the "common pool" problem so that the parties involved will act to maximize the value of the estate as a whole. Without the availability of a collective proceeding, individual collection activities may decrease the value of the debtor, injuring its creditors as a group.¹²⁸ The Code's emphasis on coercing cooperation among the parties involved in a bankruptcy proceeding suggests that the primary purpose of the cramdown power must be to prevent creditors from *unreasonably* withholding consent from a plan.¹²⁹

Absent cramdown power, the right to foreclose on the collateral would essentially give the secured creditor a "veto" power over the reorganization. The secured creditor's right to withdraw important property from the debtor makes the other parties vulnerable to being "held-up." This would allow the secured creditor to act opportunistically by conditioning its approval of the debtor's retention of the collateral on the receipt of more than its "fair share" from the reorganization. Stated more bluntly, the secured creditor could "extort" payment from the other parties in return for its consent.¹³⁰ Presenting the secured creditor with the opportunity to receive more than its claim is worth may tempt it into undesirable gamesmanship.

Strategic behavior by the secured creditor will have a number of undesirable consequences. First, it will waste resources from the estate as the parties posture and negotiate over the size of the secured creditor's "bonus." Second, negotiation would delay the reorganization proceedings, contradicting the Code's goals of speed and simplicity.¹³¹

128. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* (1986).

129. For purposes of this Section, a "reasonable" creditor is one that is indifferent between two options of identical value.

130. See *In re River Village Assocs.*, 161 B.R. 127, 138 (Bankr. E.D. Pa. 1993) (noting that the debtor's need to rely on the creditor as its sole source for funding will "unfairly increase the secured creditor's bargaining power during the plan negotiation process"); *In re SM 104 Ltd.*, 160 B.R. 202, 232 (Bankr. S.D. Fla. 1993) (describing a market for forced loans as "economically inefficient" because "[v]ulture capitalists" can exploit the debtor's vulnerable position "to extract a premium by charging an interest rate in excess of the actual risks of the loan").

131. See *In re Wichmann*, 77 B.R. 718, 720 (Bankr. D. Neb. 1987).

Finally, if the secured creditor is too "hard-nosed," it could kill the entire reorganization. If the reorganization fails, there is little cost to the secured creditor as it could take the collateral's liquidation value and walk away.¹³²

Cramdown allows the approval of a plan over the dissent of the secured creditor, but protects the secured creditor's reasonable property interest.¹³³ Thus, the creditor's hold-out power is circumvented, allowing the reorganization to go forward. At the same time, the secured creditor is protected from having to bear risk from the reorganization.

The purpose of the cramdown provision, therefore, is to balance the protection of the secured creditor's property rights with the interest of the estate as a whole in a successful and efficient reorganization. The creditor is entitled to the exact value of its claim: Nothing more and nothing less. By stripping the secured creditor of its veto power, cramdown ensures that the secured creditor does not get "too much" from the reorganization. By providing the present value of its claim, it is protected from getting "too little." Restated, cramdown should make *reasonable* creditors indifferent between foreclosure and continuation of the loan.¹³⁴ Because the opportunity cost determines

132. The only cost would be the opportunity cost of the "bribe" it turned down in hopes of receiving a larger one. If the secured creditor is a repeat player, as many financial institutions are, this one-time miscalculation may be a worthwhile investment in its reputation as a "tough bargainer." Thus, the lost opportunity in this case may be offset by larger returns in future cases. See A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 18-20, 2d ed. (1989). The Code has no interest in encouraging the playing of these "chicken" games.

133. It can be said that cramdown provides a "liability" rule in the sense discussed by Calabresi and Melamed for the secured creditor's property right in its secured claim. Guido Calabresi and A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). Its property right to veto the reorganization by foreclosing on its secured claim can be taken from it so long as appropriate "damages" are paid. "Damages" in the cramdown context are the secured creditor's entitlement to reasonable compensation for the delay in collecting on its claim: i.e., the present value of the claim.

Liability rules are common where the possibility of opportunistic behavior is high and damages can be measured accurately. In the cramdown context, both of these conditions are met. The possibility of strategic behavior is discussed in the text. Because of the ubiquitousness of financial markets, damages can also be measured with a high degree of accuracy. See Posner, *supra* note 118, § 3.9, p. 70.

If the creditor's right to foreclose upon default were protected by a "property" rule, then the right could not be taken without the creditor's permission. The creditor could require that the other parties bargain with it to postpone its foreclosure. This would only be appropriate where the possibility of strategic behavior were low and/or damages were difficult to measure because of a lack of a reliable market (as with unique goods), or the presence of subjective or idiosyncratic value. *Id.* Neither condition is present here.

134. This solves a potential paradox in the Code. The fact that the secured creditor has to be crammed-down at all seems to suggest that it is not indifferent between its options of foreclosing on the collateral or receiving the present value of the loan. From this, it could be supposed that the Code does not care whether the creditor is indifferent. Indeed, it suggests

the real value of the loan to the creditor, only the new loan approach will be consistent with the cramdown policy goal of leaving reasonable secured creditor's indifferent between cramdown and foreclosure.

VII. CONCLUSION

Most courts have agreed that the proper measure for the cramdown of a secured or priority creditor is the rate at which the lender could charge the debtor for a "new loan." None of the courts adopting this approach, however, have adequately demonstrated why this rule is preferable to other market rates, such as the creditor's cost of funds rate. This article has demonstrated that the majority rule is correct because of the undesirable systemic effects resulting from an alternative rule. Only the rate that the creditor can charge for a "new loan" will fully compensate the creditor for the delay in its receipt of payment, and thereby avoids these unintended consequences. Only the new loan approach provides creditors subject to cramdown with "deferred cash payments, of a value as of the effective date of the plan, equal to the allowed amount of such claim. . . ." As a result, the cost of funds approach should be rejected for all cramdown provisions in the Code, in favor of the new loan approach. The debtor's, not the creditor's, interest rate is all that matters.

that the Code can impose the disfavored option on the creditor, thereby making it worse off.

The discussion in the text solves this paradox. The Code is only concerned with the rights of reasonable creditors. The paradox results from the Code's prohibition on the creditors acting unreasonably to gain strategic advantage. No rational secured creditor would voluntarily surrender the right to act strategically, as the costs of doing so are externalized to the other parties to the reorganization, while it receives the full gains from its opportunistic behavior. The cramdown provision forcibly takes away these quasi-rents produced by strategic behavior.

