Commercial Real Estate Chapter 11:

Cramdown Dangers and Defenses

When a CRE borrower files for Chapter 11 bankruptcy, what are the implications for the lender? There are ways lenders can mitigate bankruptcy's impact on the economic value of its note and mortgage.

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ONE OF THE worst things that can happen to a mortgage holder or other secured lender in Chapter 11 is a "cramdown" bankruptcy plan, where the lender is forced to accept a plan containing terms to which it vehemently objects.[1]

Typically, a Chapter 11 plan attempts to extend the maturity of the loan and to pay the lender an interest rate that is less than an equitable risk-adjusted market rate. The interest rate ultimately approved by the court is likely to be considered even more egregious when the lender subsequently evaluates the resulting risk rating and the economic impact to its balance sheet.

Many borrowers cannot refinance through conventional channels because of the hangover from the Great Recession, as reflected in:

- The abundance of over-leveraged maturing CRE loans.
- Low effective rents and occupancy rates.
- The difficulty of securing refinancing for many property types collectively.

As a result, many commercial real estate owners understandably—and ironically—view a Chapter 11 cramdown as an attractive and viable avenue to refinance, particularly if the only other option is foreclosure or a dilution of ownership or control in order to generate new equity capital.

The economic impact of a crammed-down term loan on a lender can be devastating. In addition to an inequitable risk-adjusted interest rate, it's not unusual for the lender to

end up holding a term loan of five, seven, or even 10 years. Additional impacts include the following:

- The loan-to-value is likely to approximate 100% at origination.
- The amortization period may be stretched beyond what is commercially reasonable.
- Basic covenants and controls may not be included.

Any number of other transaction-specific risks that would ordinarily be negotiated and included in the loan documents may be overlooked or waived by the court.

Following a successful cramdown, the harsh accounting reality for the lender may include a troubled debt restructure, nonaccrual status, and/or a perpetually criticized asset, with requisite adverse impacts to reserves, charge-offs, earnings, and overall credit quality. Additionally, given the post-confirmation loan terms granted a debtor, the value that a lender could realize from a post-bankruptcy note sale as an exit strategy may be materially less than it was pre-bankruptcy. These adverse impacts require careful consideration of all options in any commercial workout or distressed asset that involves commercial real estate.

A legal bankruptcy professional can help a lender understand, assess, and develop an effective workout strategy that maximizes the net present value of the asset and concurrently minimizes the negative economic consequences to the lender.

When commercial real estate borrowers file Chapter 11, all is not lost. Banks can secure dismissal or liquidation if legal strategies and defenses to cramdown are applied. Even if a plan is confirmed, the lender holding a crammed-down note and mortgage may find that these defenses make the asset worth materially more than it would have been without representation during the bankruptcy proceeding.

Table 1

Key Variables	Debtor's Proposed Plan	Fair and Equitable Alternative as Supported by Lender's Defense Team
Loan amount	$5,000,000	$5,000,000
Interest rate	4.75%	7.75%
Amortization	25 years	15 years
Loan term	10 years	5 years
Probability of default at maturity /Ability to refinance	Very high/Remote	Average/Average
Expected loss/Discount at maturity	20%	0%
Required yield to note buyer:	20%	14%
Economic value of note/mortgage to lender post confirmation:	$2,038,001	$4,102,501

Generally, a Chapter 11 filing involves many complicated elements in terms of legal requirements, options, considerations, and strategies. This article focuses on two key elements required in any Chapter 11 plan. Both have material impacts on the chances of successful plan confirmation:

1. Plan interest rate: *Till v. SCS Credit Corp.*
2. Net present value versus liquidation value: best-interest-of-creditors test.

Plan Interest Rate: Till v. SCS Credit Corp.

Till v. SCS Credit Corp. was a Chapter 13 consumer bankruptcy case, where the issue centered on how to compute the interest rate to be paid to the holder of a lien on a used truck. In *Till*, the U.S. Supreme Court reviewed and considered a number of approaches for establishing interest rates in a debtor reorganization. While the formula approach was one of four considered and was deemed the least inappropriate, the court, in generating its non-unanimous verdict, recognized the flaws of using only that approach. The *Till* justices agreed that plan interest rates needed to reflect both the time value of money and the risk of default and nonpayment.

The decision of the U.S. Supreme Court in *Till*[2] has been used by many in bankruptcy court to limit the interest rate to a fixed rate based on the then current prime rate plus a small premium. This premium is typically based on a loose and undefined interpretation of the specific risk factors in the debtor's proposed plan. It often does not take into account either amortization or whether the proposed plan term is three, five, seven, or even 10 years.

To the extent that a lender's bankruptcy defense team can provide a credible expert witness to define the specific risk variables involved in the debtor's plan and then articulate the justification for why the proposed interest rate is unfair to the lender, two important things happen. First, the value of the crammed-down note, if sold by the lender post bankruptcy, is materially impacted by a higher rate of interest, a shorter term, and a commercially reasonable amortization.

Second, with a higher interest rate and a higher debt service burden, it generally becomes more difficult for the debtor to prove plan feasibility, another element required by

the court before confirmation can be granted to a Chapter 11 debtor.

To see the impact on economic value, assume the debtor proposed a 4.75% interest rate for 10 years in its $5 million plan (crammed down to settle a $7.6 million outstanding debt). The debtor also proposed a 25-year amortization on a 29-year-old asset with an estimated remaining useful life of 22 years. Bankruptcy counsel and an independent, credible expert witness can articulate for the judge each element of the risk profile present in the plan, attesting to what the interest rate, term, and amortization should be in order to be fair and equitable to the lender.

If the lender is not successful in getting the court to modify the debtor's proposed plan, the economic consequences can be dramatic—exceeding $2 million on a $5 million successful cramdown, as shown in Table 1.

Similarly, if successfully demonstrated to the court that the debtor's proposed plan should include a higher interest rate and amortization in order to be fair and equitable to the lender, the debtor's burden to prove plan feasibility is now a higher hurdle given the increased annual debt service payments, which have grown to $564,765 from $342,070. This successful argument therefore undermines the debtor's chances for a successful cramdown and increases the likelihood of settlement or of the lender securing its collateral.

Even if the debtor's plan is still approved by the court, the financial impact on the residual value is dramatic. In the example above, the lender saved $2 million when its defense team successfully amended the debtor's plan only as it related to interest rate, term, and/or amortization.

Net Present Value versus Liquidation Value

The bankruptcy courts that apply some version of *Till* in Chapter 11 have crammed down on the lender interest rates that are harshly low compared to the contract rate or the market rate. Another way to defeat such a plan is to focus on another requirement of confirmation, which is that a nonaccepting lender must receive at least as much under the plan as it would in a Chapter 7 liquidation. This is determined through what is commonly called the best-interest-of-creditors test.[3]

When a debtor's Chapter 11 plan proposes to extend the loan term and provides for the payment of a *Till* rate of interest until maturity, the lender receives a stream of payments. The lender is entitled to have the court value that stream of payments to see whether its present value is at least as much as the lender would receive in a Chapter 7 liquidation. If the present value is less than the lender would receive in a liquidation, then the court should not confirm the plan.

In determining the present value of the stream of payments, it is necessary to apply a discount rate. To find an appropriate discount rate, an expert witness in real estate, finance, and loan-risk modeling must be able to identify, consider, and articulate all of the risk factors and variables for each specific plan and debtor. Key variables and risk factors may include loan term, collateral adequacy and marketability, cash flow projections, cash flow stability or volatility, debt service coverage and debt yield, business trends, capital market access, and support provided by the owners. No two transactions are the same, and every proposed plan poses unique risks and variables to a lender.

An expert witness familiar with loan-risk modeling can consider all specific variables and risks for each plan and then arrive at a supportable discount rate for the proposed stream of payments. The expert can then

Table 2

Key Variables	Debtor's Proposed Plan		Fair and Equitable Alternative as Supported by Lender's Defense Team
Loan amount	$5,000,000		
Interest rate	4.75%		
Amortization	25 years		
Loan term	10 years		
Annual debt service payments	$342,070		
Probability of default at maturity / Ability to refinance	Very high / Remote		
Expected loss / Discount at maturity	20%		
Expected residual at balloon	$2,931,828	Property Value	$5,000,000
Required discount rate	20%	Estimated Closing Costs (6%)	$300,000
Economic value of note/ mortgage to lender post confirmation:	$2,038,001	No liquidated value to lender	$4,700,000

> When such risk variables support a significant risk premium in the Till interest rate, it typically undermines not only feasibility, but also the best-interest-of-creditors test through a more punitive discount rate.

apply that discount rate to the stream of payments and determine present value. If that present value is less than the liquidation value of the property, then the debtor's plan fails the best-interest-of-creditors test and the court should not confirm the plan.

This best-interest-of-creditors test can be demonstrated using the example above. Assuming the appropriate discount rate for the debtor's proposed plan was 20%, the net present value of the forecasted net stream of payments to a prospective purchaser valuing that stream is $2,038,001, as illustrated in Table 2.

Comparing the $2,038,001 net present value of the payment stream to the $4.7 million liquidated value that the secured lender would receive if the plan is not confirmed provides evidence that the debtor's plan does not meet the best-interest-of-creditors test and therefore should not be crammed down on the lender.

This conclusion was one of the grounds on which one bankruptcy court denied confirmation of a plan.4 Therefore, even when a Chapter 11 plan may be confirmable, the lender may still be able to defeat it based on the best-interest-of-creditors test.

A secured lender has numerous other protections and remedies in Chapter 11, including 1) the right to contest the debtor's valuation of collateral at an amount below that of the mortgage or lien; 2) the exercise of the § 1111(b)(2) election to have a secured claim for the full amount of the claim, even if the court values the collateral for less than that full amount; and 3) the right to challenge the feasibility of the plan. But the lender should not overlook the best-interest-of-creditors test, which could show that liquidation of the collateral at the time of the confirmation hearing may produce more for the lender than the net present value of the stream of payments proposed in the plan.

Feasibility, the Till interest rate, the applicable discount rate, and equity and fairness are all inextricably linked. A plan offering a reasonable probability of repayment and a reasonable loan structure with demonstrated and disclosed sources of repayment can command an interest rate in Chapter 11 bankruptcy that is not completely inconsistent with conventional market terms. However, when transaction-specific risk variables are present that undermine the reasonable chance of repayment without intervening default and/or loss, the risk premium above a market-derived, conventional interest rate becomes significant.

When such risk variables support a significant risk premium in the Till interest rate, it typically undermines not only feasibility, but also the best-interest-of-creditors test through a more punitive discount rate. It serves as a red flag that certain elements of a plan are likely unfair or inequitable to the lender.

It is critical for lenders to have an experienced bankruptcy defense team representing them in order to improve the chances of defeating cramdown and to maximize the residual value of the lender's note and mortgage if cramdown is unavoidable. ❖

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Notes

1. Bankruptcy Code section 1129(b).
2. Till v. SCS Credit Corp., 541 U.S. 465 (2004.)
3. Bankruptcy Code section 1129(a)(7)(ii).
4. In Re Storage Masters, Memorandum Opinion dated July 24, 2012 (Bkrtcy MD Fla. 2012, Chief Judge Karen S. Jennemann) (Document No. 190, Page 17, et seq.).