AN ANALYSIS OF THE ADVANTAGES OF NON-MARKET BASED APPROACHES FOR DETERMINING CHAPTER 11 CRAMDOWN RATES: A LEGAL AND FINANCIAL PERSPECTIVE

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I. INTRODUCTION

As litigation involving corporate matters became increasingly more technical in the twentieth century, principles of corporate finance began to play a major role in shaping many judicial opinions involving corporate, securities, and bankruptcy law. The theoretical underpinnings of the bankruptcy laws and the federal securities laws have necessitated a certain degree of judicial deference towards expert witnesses with professional backgrounds in finance and accounting. Not surprisingly, bankruptcy courts in New York and Delaware frequently hear legal issues relating to these developments as distressed businesses tend to exhibit fairly complex capital structures and large amounts of secured debt. One of these issues is whether or not a court should defer to the credit markets in determining the appropriate rate of interest used to calculate deferred payments to secured lenders in a chapter 11 plan. This Comment will discuss how and why, in making such a determination, the concept of market efficiency is crucial.

In *Till v. SCS Credit Corp.*, the Supreme Court of the United States addressed the issue of how a bankruptcy court should determine the interest rate used to discount deferred payments to secured lenders in a chapter 13 plan of debt readjustment.[1] The plurality in *Till* held that the United States Bankruptcy Code (the "Code") requires judges to

[1] Till v. SCS Credit Corp., 541 U.S. 465 (2003) (holding that the formula approach must be used to determine the interest rate paid to secured lenders in a chapter 13 plan of debt readjustment).

apply the "formula approach."[2] This method involves selecting a relevant risk-free rate and adjusting upwards in accordance with the debtor's risk of default in order to ensure that the present value of the future cash payments equals the allowed secured claim.[3]

Since 2003, when the *Till* opinion was written, courts and commentators have debated its applicability in chapter 11 cases,[4] specifically with regard to Section 1129(b) of the Code. The bankruptcy bar's interest in this topic was reinvigorated in 2014 when Judge Robert Drain of the United States Bankruptcy Court for the Southern District of New York issued a lengthy ruling heavily devoted to secured lender treatment in a chapter 11 cramdown.[5] Interest rate determination was one of the primary contested matters when both the first and the 1.5 lien noteholders[6] asserted that Section 1129(b)(2)(A)(i)(II) of the Code mandated a higher rate than the one offered under the plan.[7] More specifically, they advocated for the "coerced loan approach": the rate that a creditor could obtain if he were to foreclose on the collateral and reinvest the proceeds in a loan of comparable duration and risk to the one issued to the debtor under the plan.[8] Notwithstanding the fact that the Supreme Court had already rejected the coerced loan approach in the chapter 13 context in *Till*, the indenture trustees asserted that *Till*'s holding did not apply to chapter 11 cases and that market rates should be used as proxies instead.[9] The debtor ("Momentive"), on the other hand, arrived at the appropriate discount rate

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[2]   *Id.* at 479–80.

[3]   *Id.* at 479.

[4]   *See generally, e.g.*, Gary W. Marsh & Matthew W. Weiss, *Chapter 11 Interest Rates After* Till, 84 AM. BANKR. L.J. 209 (2010); Jason A. Pill, *Un*till *the Footnote Was Written: The Effect of* Till v. SCS Credit Corporation *On 11 U.S.C. § 1129(b)(2)*, 26 EMORY BANKR. DEV. J. 267 (2010); Mark J. Thompson & Katie M. McDonough, *Lost in Translation:* Till v. SCS Credit Corp. *and the Mistaken Transfer of a Consumer Bankruptcy Repayment Formula to Chapter 11 Reorganizations*, 20 FORDHAM J. CORP. & FIN. L. 893 (2015); Daniel R. Wong, *Chapter 11 Bankruptcy and Cramdowns: Adopting a Contract Rate Approach*, 106 NW. U. L. REV. 1927 (2012).

[5]   *In re* MPM Silicones, LLC, No. 14-22503-rdd, 2014 Bankr. LEXIS 3926, at *1 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015). In the text of this Comment, the author will hereinafter refer to *In re MPM Silicones, LLC* as "*Momentive.*"

[6]   After the senior secured creditor is paid in full, 1.5 lien noteholders are entitled to satisfaction of their claims with the remaining proceeds of the sale of collateral and may be issued in connection with an exchange offer. *See, e.g.*, Matthew DiLallo, *Chesapeake Energy Corporation Considers Another Tactic to Address Looming Debt Maturities*, THE MOTLEY FOOL (Apr. 19, 2016, 12:30 PM) http://www.fool.com/investing/general/2016/03/18/chesapeake-energy-corporation-considers-another-ta.aspx.

[7]   *In re MPM Silicones*, 2014 Bankr. LEXIS 3926, at *71.

[8]   *Id.* at *71, 82.

[9]   *Id.*

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by taking the seven-year treasury yield and adjusting this figure by a risk-premium associated with the restructured debtor.[10] The debtor arrived at this figure using the formula approach, the very same method endorsed by the *Till* Court eleven years earlier.[11] In confirming the plan, Judge Drain rejected the coerced loan approach as inconsistent with the policy behind the Code.[12] Notably, he held that *Till* is not only binding precedent in the chapter 13 context, but in the chapter 11 context as well.[13]

The confirmation of Momentive's cramdown plan elicited widespread coverage and attention from the financial and legal press, distressed debt investors, and financial sponsors.[14] Since incremental changes in the discount rate can amount to millions of dollars for secured lenders in chapter 11 cases, this was far from unexpected.[15] Moreover, since the various financial institutions involved in the chapter 11 process are frequently willing to devote a substantial number of resources to litigate matters such as these, the issue of cramdown rate determination in chapter 11 will likely be heard by a United States Court of Appeals[16] in the near future.[17] Accordingly, this Comment hopes to serve as a guide for bankruptcy and appellate courts alike

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[10]   *Id.* at *70–71.

[11]   *Id.*

[12]   *See id.* at *73–74.

[13]   *In re MPM Silicones*, 2014 Bankr. LEXIS 3926, at *72–73.

[14]   *See, e.g.*, Stephen J. Lubben, *Judge's Ruling Could Affect Bondholders in Corporate Bankruptcies,* N.Y. TIMES (Oct. 1, 2014, 3:49 PM), http://dealbook.nytimes.com/2014/08/28/judges-ruling-could-affect-bondholders-in-corporate-bankruptcies/; Nathan Vardi, *Leon Black's Apollo Global Management Keeps Winning Battles And Outmaneuvering Creditors,* FORBES (Aug. 28, 2014, 8:25 AM), http://www.forbes.com/sites/nathanvardi/2014/08/28/leon-blacks-apollo-global-management-keeps-winning-battles-and-outmaneuvering-creditors/#415a8101356d; Matt Wirz, Momentive *Ruling Shakes Up Debt Markets,* WALL ST. J. (Aug. 28, 2014, 10:14 AM), http://blogs.wsj.com/moneybeat/2014/08/28/momentive-ruling-shakes-up-debt-markets/. This reaction was not surprising as Judge Drain made numerous determinations that could potentially have a substantial impact on the rights of secured lenders in chapter 11 bankruptcies; most significantly, the standard for determining whether an indenture entitles a creditor to a "make-whole" call premium upon repayment of principal in bankruptcy.

[15]   For example, the outstanding principal on Momentive's first and 1.5 lien replacement notes is approximately $1.3 billion.

[16]   This includes United States District Courts exercising appellate jurisdiction under 28 U.S.C. § 158(a) (2012).

[17]   Indeed, the United States District Court for the Southern District of New York affirmed Judge Drain's opinion as this Comment was being written. U.S. Bank N.A. v. Wilmington Sav. Fund Soc'y (*In re* MPM Silicones, LLC), 531 B.R. 321 (S.D.N.Y. 2015). The case is currently on appeal to the United States Court of Appeals for the Second Circuit.

when they are confronted with the task of calculating the appropriate interest rate in a chapter 11 cramdown plan. Unlike other commentators who have addressed this topic in the past, this Comment seeks to provide a unique perspective from both a legal and financial standpoint. As determined above, the latter is of grave importance because many courts have held that *Till* footnote 14 suggests that the coerced loan approach might be ideal in chapter 11 cases if parties can demonstrate that the interest rates to be used as proxies are the product of an "efficient market."[18] Nonetheless, courts taking footnote 14's directive have often applied standards that depart from the principles articulated in the "Efficient Capital Markets Hypothesis,"[19] patently endorsed by the United States Supreme Court in *Basic Inc. v. Levinson.*[20] This Comment will argue why these general principles should be relevant to the inquiry suggested by *Till* footnote 14. Additionally, it will augment the *Momentive* court's assertion that interest rates of exit facilities to companies emerging from chapter 11 and comparable debtors may not be efficient. Although footnote 14 states that it might make sense to "ask what rate an efficient market [for loans to entities comparable to a debtor] would produce" in chapter 11, this Comment will discuss why this is a very difficult question to answer in practice and why such inquiry may be futile.

Part II of this Comment will provide an overview of cramdown plans of reorganization under Section 1129(b) of the Code. Part III will explain the concepts of discounting and present value, and it will examine why they are important with regard to secured creditor treatment in chapter 11. Part IV will analyze the *Till* decision in detail and discuss the post-*Till* case law on the requirements of Section 1129(b)(2)(A)(i)(II), most notably *Momentive* and *Bank of Montreal v. Official Committee of Unsecured Creditors (In re American HomePatient, Inc.)*[21] by focusing on two aspects of the analysis: (1) whether the court chose to endorse the formula approach or a two-stepped coerced loan approach; and (2) the court's policy justifications for doing so. In cases where the court adopted the two-stepped coerced loan approach, Part

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[18]   *See infra* Part V.

[19]   *See infra* Part V. *See also* Pill, *supra* note 4, at 290 ("While the term 'efficient market' has a commonly used definition in securities litigation, the question remains whether bankruptcy courts will transpose the definition into the bankruptcy arena.").

[20]   *See, e.g.*, Michael Simkovic & Benjamin S. Kaminetzky, *Leveraged Buyout Bankruptcies, the Problem of Hindsight Bias, and the Credit Default Swap Solution,* 2011 COLUM. BUS. L. REV. 118, 157 n.124 (2011) ("In the parlance of economists, the Supreme Court has accepted the semi-strong form of the Efficient Market Hypothesis." (citing Basic Inc. v. Levinson, 485 U.S. 224, 244 (1988))).

[21]   420 F.3d 559, 568 (6th Cir. 2005), *cert. denied*, 549 U.S. 942 (2006).

IV will examine how the court conducted its market efficiency analysis. Part V will argue why *Till* should apply in chapter 11 cramdowns as a matter of judicial economy and public policy, specifically contending that the purpose of the cramdown rate is to ensure that the present value of a secured lender's future cash flows equals the amount of its allowed secured claim and assert that this principle is no less relevant in the chapter 11 context.

With this policy foundation established, the Comment will consider corporate finance theory in discussing why the Efficient Capital Markets Hypothesis should be the proper standard for testing the efficiency of market rates and explain why this theory might fail when applied to credit markets relevant to a typical chapter 11 proceeding. It is important to note that Part V does not presume to determine conclusively the efficiency of modern credit markets. Individuals with advanced degrees in finance and economics will surely publish new findings in this ever-evolving field of study. Rather, the purpose of Part V is to address the manner in which lawyers view the concept of market efficiency, reconcile how definition is applied in the securities context and the chapter 11 context, and address some of the reasons why market interest rates may not be efficient. Lastly, Part VI concludes.

II. OVERVIEW OF CHAPTER 11 AND CRAMDOWN PLANS OF REORGANIZATION

Chapter 11 of the Code was designed to "strike a balance between the need of a corporate debtor in financial hardship to be made economically sound and the desire to preserve creditors' and stockholders' existing legal rights to the greatest extent possible."[22] In light of these competing policy concerns, distressed firms and their creditors have strong incentives to work with one another in devising a plan of restructuring and avoiding costly litigation whenever possible.[23] Nevertheless, obtaining unanimous consent for a plan that proposes to modify significantly the rights of numerous classes of creditors can be a daunting task. Addressing this concern, the drafters of the Code granted bankrupt businesses an extraordinary remedy—the ability to implement a binding plan of restructuring on dissenting creditors and

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[22] See Wong, *supra* note 4, at 1931 (citing 7 Collier on Bankruptcy ¶ 1100.01 (16th ed. 2014)).

[23] *See generally* 7 Collier on Bankruptcy ¶ 1100.01 (16th ed. 2014) ("The reorganization of a corporation is not a lawsuit in the ordinary sense of a procedure designed to settle issues between individual litigants, but a complex exercise of legal method, corporate finance and business management.").

claimants alike.[24]

The end goal for a "Debtor In Possession"[25] is to obtain plan confirmation.[26] A typical chapter 11 plan involves multiple changes to the firm's current capital structure. Debtors often modify the rights of secured lenders by paying out the face value of their claims over an extended period of time. General unsecured creditors may receive full or partial satisfaction of their claims[27] through some combination of immediate consideration, deferred cash compensation, equity in the newly reorganized company, and warrants to purchase equity in the new company. In some circumstances they may receive nothing at all. Equityholders of the old debtor more frequently end up with nothing.[28] The typical chapter 11 plan may also involve other significant changes to the company such as management changes, operational changes, the establishment of a litigation trust to fund the plan, and

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[24] *See generally* 11 U.S.C. § 1129(a)–(b) (2012). Under the Trust Indenture Act (TIA), which governs the issuance of certain registered debt securities in the United States, all material changes to a bond's indenture require unanimous consent of a company's bondholders. *See* Trust Indenture Act of 1939 § 316(b), 15 U.S.C. § 77ppp(b) (2012). The Bankruptcy Code enables a bond issuer to circumvent the unanimity requirement of the TIA with respect to certain debt securities.

[25] Under chapters 7 and 13 of the Code, a trustee is appointed to monitor and distribute the assets of the debtor and to represent the interests of general unsecured creditors. Generally speaking, trustees are not appointed in chapter 11. Rather, the debtor maintains operational control of its assets and becomes the "debtor in possession" (DIP). A DIP is defined as a "debtor except when a person that has qualified under section 322 of this title is serving as a trustee in the case." 11 U.S.C. § 1101(1). The DIP assumes all the rights and responsibilities of a trustee in bankruptcy and owes certain fiduciary duties to its creditors normally not owed outside of bankruptcy law. *See generally* 11 U.S.C. §§ 1107, 1108.

[26] In recent years, the use of "363 sales" has largely supplanted traditional chapter 11 plans and has become a widespread form of corporate restructuring. Broadly speaking, a DIP can sell all or substantially all of its assets to a new buyer "free and clear of any interest in such property of an entity other than the estate." 11 U.S.C. § 363(f). The buyer takes clean title to the assets, the business continues as a going concern under the control of the buyer, and the seller then distributes the cash proceeds to its creditors through a liquidating plan. Although the Code's drafters did not expressly codify this procedure, it remains the predominant form of "corporate reorganization" today. While some scholars have supported 363 sales as a powerful tool that facilitates the continuation of a distressed business as a going concern, others have criticized their widespread use for numerous reasons beyond the scope of this paper. *See generally* Stephen J. Lubben & Stephanie Ben-Ishai, *Sales or Plans: A Comparative Account of the "New" Corporate Reorganization*, 56 MCGILL L.J. 591 (2011). *But see* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007).

[27] For example, if an unsecured bondholder is owed $1000 in principal, it is legally permissible under the Code to force such bondholder to accept consideration worth substantially less than that. *See generally* 11 U.S.C. § 1123(b)(1) (a plan may "impair or leave unimpaired any class of claims, secured or unsecured, or of interests").

[28] *See id.*

sales of various segments of the debtor-in-possession's (DIP's) business.[29]

For a consensual chapter 11 plan to be confirmed by a bankruptcy judge, it must meet the requirements of Section 1129(a) of the Code.[30] Confirmation is largely dependent upon approval by each class of creditors.[31] More specifically, a voting class of creditors is deemed to have accepted the plan if half of the class members and two-thirds of the dollar value of the class' claims vote in favor of such plan.[32]

Despite a debtor's failure to obtain the necessary votes under Section 1129(a)(8), it may nonetheless force the dissenting creditors to be bound by the plan's terms. This tactic is generally referred to as "cramdown."[33] In addition to meeting all of the requirements of Section 1129(a), a cramdown plan must also satisfy the elements of Section 1129(b).[34] Broadly speaking, the two primary elements of Section 1129(b) are the requirements that the plan (1) not "unfairly discriminate" between various classes of creditors and (2) be "fair and equitable" with respect to each class of claimant.[35] Section (2) of subsection (b) defines the phrase "fair and equitable" as it applies to each general type of claim—"secured claims," "unsecured claims," and "interests."[36]

Before discussing how Section 1129(b) defines "fair and equitable" with respect to secured creditors, one must first examine how the Code defines a "secured claim." Section 506 states that a secured claim is one that is "secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title."[37] A secured claim is secured "to the extent of the value of such creditor's interest in the estate's interest in such property."[38] More succinctly, a creditor whose claim is "secured by a lien on property in which the

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[29]   *See generally* ELIZABETH WARREN & JAY WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 595–767 (Aspen Publishers, 6th ed. 2009) (discussing the chapter 11 plan negotiation and confirmation process).

[30]   11 U.S.C. § 1129(a)(1)–(16) lists the sixteen requirements a consensual plan must meet in order to be confirmed. Among these is the requirement for a court to find that the confirmation of the plan will not likely be followed by another reorganization or liquidation. § 1129(a)(11). Additionally, all classes of impaired creditors must accept the plan. § 1129(a)(8).

[31]   § 1129(a)(8).

[32]   § 1126(c).

[33]   *See generally* 7 Collier on Bankruptcy ¶ 1129.03 (16th ed. 2014).

[34]   11 U.S.C. 1129(b) (2012).

[35]   § 1129(b)(1). In Code parlance, the term "interests" in this context refers to equityholders of the old debtor.

[36]   § 1129(b)(2)(A)–(C).

[37]   11 U.S.C. § 506(a)(1)(2012).

[38]   *Id.*

estate has an interest" is treated as a secured claimant if the value of the property exceeds the value of the claim.[39] When the debt owed to such creditor exceeds the value of the collateral, however, the creditor's claim is bifurcated.[40] Under this scenario, the lender will assert: (a) a secured claim in the amount of the value of the collateral itself; and (b) an unsecured claim, if recourse exists under state law, for the remaining portion of the debt.[41] This process is also referred to as "cramdown" or "stripdown."[42]

An important exception to Section 506 exists in chapter 11. Since a chapter 11 plan often calls for an arbitrary judicial valuation of a creditor's collateral for purposes of determining the status of a secured claim, Congress enacted Section 1111(b) to protect creditors from such a valuation.[43] Outside of bankruptcy, secured lenders provide financing to a borrower with the expectation that they can look to the value of the collateral to satisfy their claims upon a default. The satisfaction of their claims comes from the cash proceeds of the sale of collateral, and no judicial valuation is necessary. When a debtor retains control over the collateral, however, a bankruptcy judge will hear expert witness testimony in order to calculate the estimated value of the collateral for purposes of determining what portion of a creditor's claim is secured and what portion is unsecured.[44] Because this process undermines a secured lender's expectations under state law, Section 1111(b) provides creditors with an alternative route. With the "1111(b) election," secured creditors have the option of waiving a deficiency claim—even if recourse was never permitted by state law—and treating the entire balance as secured to protect against an unfavorable valuation.[45]

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[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] For the remainder of this Comment, the term "cramdown" will refer to a chapter 11 plan under Section 1129(b) of the Code. The term "stripdown" will refer to the process of claims bifurcation under Section 506(a).

[43] *See* 7 Collier on Bankruptcy ¶ 1111.03[1] (16th ed. 2014) ("Congress took the position that disposition in a chapter 11 case of a creditor's collateral was not like disposition in a liquidation case because of the opportunity in chapter 11 for a disposition based on judicial valuation. Section 1111(b) thus attempts to balance the general distaste and dissatisfaction with judicial valuations of property with the need to bring some reckoning to all debtor-creditor relations. It does this by allowing secured creditors, in most situations, to elect how their claim is treated. The consequences of that election are far-reaching.").

[44] *See id.*

[45] 11 U.S.C. § 1111(b) (2012). Failure to make the "1111(b) election" provides secured lenders with the ability to participate in multiple voting classes.

With the proper definition of a secured claim established, the cramdown requirements of Section 1129(b) become easier to understand. In the cramdown setting in chapter 11, "fair and equitable" treatment of a secured claim includes the requirement that:

> "each holder of [a secured claim] 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."[46]

This allowed amount will differ depending on whether the secured claimant proceeds under Section 506(a) or Section 1111(b), as will the amount of interest owed.[47]

When a plan calls for an immediate lump-sum cash payment to a secured creditor, application of Section 1129(b)(2)(A)(i)(II) is straightforward: the debtor-in-possession must pay the full value of the allowed secured claim if the cramdown plan is to be confirmed. Often, however, a distressed business cannot afford to pay these claims in full on the effective date of a plan. As a result, the secured lender is granted a note in lieu of a lump-sum payment.[48] Section 1129(b)(2)(A)(i)(II) mandates that the noteholder receive additional compensation for these deferred payments.[49] A note fails to meet the requirements of Section 1129(b)(2)(A)(i)(II) if it "bears no interest or if it bears insufficient interest *to discount the payment to the allowed amount of the claim.* In the language of the Code, the property thus given—the note—does not 'have value, as of the effective date,' of the allowed amount of the claim."[50] Despite universal agreement that the "time value of money" must be taken into consideration in any cramdown plan providing for deferred payments, courts remain divided on the issue of how to determine the proper interest rate. The Comment's remainder will focus in detail on this topic.

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[46]   § 1129(b)(2)(A)(i)(II) (emphasis added).

[47]   Under Section 1111(b), the creditor's recovery is capped at the nominal value of the claim. *See infra* Part III.

[48]   *See, e.g.,* U.S. Bank N.A. v. Wilmington Sav. Fund Soc'y (*In re* MPM Silicones, LLC), 531 B.R. 321, 326 (S.D.N.Y. 2015).

[49]   7 Collier on Bankruptcy ¶ 1129.03 (16th ed. 2014) (quoting 11 U.S.C. § 1129(b)(2)(A)(i)(II)(2012)) (emphasis added).

[50]   *Id.*

III. OVERVIEW OF DISCOUNTING AND THE PRESENT VALUE OF A NOTE

In determining the "value" of a secured creditor's note under a chapter 11 plan, a court must discount the cash flows generated by the note.[51] Since the Code mandates that any deferred cash payments must equal the total value of the secured claim if it were paid in full today, a court must "translate all future cash flows into 'today dollars.' Only by making this adjustment can [a court] directly compare the amounts."[52]

When a secured creditor receives a note as part of a cramdown plan, the constant cash flows generated by such note can be referred to as an "annuity" in financial-speak.[53] These payments have the effect of reducing the amount of principal owed by the debtor at the end of each period.[54] In each subsequent period, a greater portion of the payment will offset the principal, a process known as "amortization."[55]

As stated in Part II, the present value of the cash flows generated by the note must equal the "allowed amount" of the secured lender's claim. In order to calculate the present value of the future payments, each payment is "discounted" back to "today dollars" based on when such payment is received. The present value of the note is simply the sum of the present values of each payment generated by the note. With the interest rate "r," time period "t," and the constant payment "C," one can calculate this sum by applying the following formula:

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[51] *See id.*

[52] STEPHEN J. LUBBEN, CORPORATE FINANCE 23 (Wolters Kluwer Law & Business, 1st ed. 2014).

[53] *Id.* at 29.

[54] *See id.*

[55] RICHARD A. BREALEY, STEWART C. MYERS, & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 44–45 (Michele Janicek et al. eds., 9th ed. 2008). In the case of a replacement note granted to a secured lender in chapter 11, the principal is simply the allowed secured claim. *Id.*

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Figure 1: Present Value of an Annuity[56]

$$PV = \frac{C}{r} * \left[1 - \frac{1}{\left(1+r\right)^t} \right]$$

Because the Code mandates that the "PV" of the cash flows must equal the allowed secured claim, a constant, determining "C" and "r" is most relevant. The equation can be rearranged to solve for this required annual payment to the secured creditor under the plan as a function of the discount rate "r":

Figure 2: Allowed Secured Claim Under Section 506 as an Annuity

$$Secured\ Claim = \frac{C}{r} * \left[1 - \frac{1}{\left(1+r\right)^t} \right]$$

Figure 3: Required Annual Payments to a Secured Creditor via a Note with Constant Payments

$$C = \frac{r * Secured\ Claim}{\left(1 - \frac{1}{(1+r)^t} \right)}$$

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[56] LUBBEN, *supra* note 52, at 29. If the note calls for periodic interest payments, followed by payment of principal at the maturity date, the formula can be modified by adding a term that discounts the principal at maturity (most corporate bonds are structured this way). The "yield," "r," represents the rate of return on the note while "C" is the nominal value of the coupon payments. Any increase in the bond's present value, or price, must be accompanied by a corresponding decrease in the yield. Regardless of whether the replacement note is structured as an annuity or a bond, the allowed secured claim must equal the present value of the future cash flows generated by such instrument. *Id.* at 66–67.

This formula reveals that the each payment must equal the allowed secured claim divided by the annuity formula from Figure 1 with constant payments of one dollar and discount rate "r." A more complex mathematical analysis of this formula will show that an increase in the interest rate "r" will always lead to a lower present value of an annuity.[57] Since the required annual payment to the secured lender is equal to the allowed secured claim divided by the present value of an annuity with payments of one dollar, it follows that a decrease in the present value of the annuity results in a larger required payment to the secured creditor. The formula above can be simplified by referring to "one over the present value of the annuity with constant payments of $1" as the "discount factor" given an interest rate "r" and "t" number of payments. Based on the above, we see that C increases as the discount factor increases.

Figure 4: Simplified Formula

C = Secured Claim x Discount Factor

When a secured creditor chooses to make an 1111(b) election, the calculation entails an additional element. In addition to receiving cash flows whose present value equals that of the collateral, a secured lender must also receive cash flows totaling the *nominal* value of the allowed claim.[58] The formula changes accordingly:[59]

Figure 5: Value of a Secured Lender's Note Payments with 1111(b) Election

$$C = Max\left[\text{Collateral Value x Discount Factor,}\ \frac{\textit{Secured Claim}}{t}\right]$$

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[58]   *See generally* 11 U.S.C. § 1111(b) (2012).
[59]   It is important to note that in a Section 1111(b) scenario, the lender's allowed secured claim is not necessarily equal to the value of the underlying collateral.

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More frequently, corporate bonds are structured in a way that provides investors with semi-annual interest payments, or "coupons," and repayment of principal at maturity.[60] When these debt instruments are freely tradable on a secondary market, the actual rate of return can differ from the coupon.[61] For example, a six percent note would entitle the holder to semi-annual coupon payments of thirty dollars. The present value formula is the same as in Figure 1; however, an additional term must be added to the equation to account for the present value of the $1000 principal at maturity.

Figure 6: Bond Pricing Formula

$$PV(SC) = \frac{C}{r} * \left[1 - \frac{1}{(1+r)^t} \right] + \frac{1,000}{(1+r)^t}$$

In an active secondary market, the purchase price a buyer is willing to pay for the note is simply the present value of these payments. The interest rate, indicated by "r," or the "yield," is the discount rate that sets the present value of the coupons and principal equal to the price. If a rational investor perceives the six percent bond to be less risky than its coupon warrants, it will pay a premium for the debt instrument. Accordingly, the yield will fall below six percent. Under this formula, price and yield are inversely related. In the context of a chapter 11 cramdown, if "C" is equal to "r," the note will trade at 100% of the value of the secured claim. If "C" exceeds "r," the debt will trade at a premium.

In corporate finance, calculating the appropriate yield is relatively straightforward: in order to ensure that the equation in Figure 1 balances out, note payments should be discounted at a rate that focuses on the likelihood of repayment.[62] Aside from the firm-specific risk, some other factors to consider include duration, inflation, and the

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[60]   LUBBEN, *supra* note 52, at 29

[61]   *Id.*

[62]   *See generally* LUBBEN, *supra* note 52, at 35–49.

value of any underlying collateral.[63] An interest rate that properly incorporates these factors is more likely to provide an accurate valuation of the note itself.[64] Arriving at the proper figure under the supervision of a bankruptcy court, however, remains a divisive issue. Part IV will discuss how courts have addressed the competing approaches for determining the proper rates within the chapter 13 and chapter 11 contexts.

IV. *TILL* AND THE CASES THAT FOLLOW

The seminal case addressing the competing methods for interest rate determination is *Till v. SCS Credit Corp.*[65] Although this case deals with cramming down a secured lender in chapter 13 as opposed to chapter 11, the take-away from Part III is equally relevant in each instance: secured lenders will always favor the approach that yields the highest "C." Moreover, chapter 13 is similar to chapter 11 in that it provides individuals and households with the ability to restructure their debts under the protection of the bankruptcy court.[66] A typical chapter 13 plan consists of three or five years of constant payments to secured and unsecured creditors alike.[67] Unlike in chapter 11, however, the requirements for plan confirmation are purely statutory, and no voting is necessary.[68] If a debtor meets the requirements of Section 1325 of the Code, a court will confirm his or her plan.[69] The rights of secured creditors in chapter 13 are addressed in Section 1325(a)(5)(B). As in chapter 11, secured claims must be paid in full over the course of the plan.[70] Also, like chapter 11, the statute "does not mention the term 'discount rate' or the world 'interest.'"[71] Still, the Supreme Court had previously held that, with regard to deferred payments to secured creditors, courts must "discount . . . [a] stream of deferred payments back to the[ir] present dollar value."[72] The only contested issue going into *Till* was the specific interest rate required to calculate these deferred payments.[73]

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[63]   *Id.*

[64]   *See id.*

[65]   541 U.S. 465 (2004).

[66]   *See generally* 11 U.S.C. §§ 1301–1330 (2012).

[67]   *See* § 1322(a)–(d).

[68]   § 1325(a).

[69]   *Id.*

[70]   § 1325(a)(5)(B)(ii).

[71]   Till v. SCS Credit Corp., 541 U.S. 465, 473 (2004).

[72]   Rake v. Wade, 508 U.S. 464, 472 n.8 (1993).

[73]   *Till,* 541 U.S. at 473.

Since *Till* was decided, federal courts remain divided as to whether or not its holding applies in chapter 11. Moreover, courts and commentators have noted that because the opinion was a plurality, its precedential value is debatable since it is unclear how exactly the Court would rule on this issue in the future.[74] Nonetheless, because most courts have relied on this case to guide their calculation in the chapter 11 context, *Till* is always a good starting point for any cramdown rate analysis.

A. *Till v. SCS Credit Corp.: SCOTUS Adopts the Formula Approach in Chapter 13*

In *Till*, the petitioners filed for chapter 13 bankruptcy protection in 1999.[75] The petitioners' chapter 13 plan provided that they would pay "interest on the secured portion of respondent's claim at a rate of 9.5% per year."[76] The respondent, an automobile lender with a purchase money security interest in the debtors' truck,[77] contended that it was entitled to a rate of twenty-one percent because this was the rate "it would [have] obtain[ed] if it could [have] foreclose[d] on the vehicle and reinvest[ed] the proceeds in loans of equivalent duration and risk as the loan" granted to petitioners—the coerced loan rate.[78] After a lengthy and convoluted appeals process, the Supreme Court granted certiorari to determine which approach should be used for calculating the discount rate on a secured lender's deferred plan payments in chapter 13.[79] The Court addressed four methods of interest rate determination.

1. The Coerced Loan Approach

The coerced loan approach, advocated by the secured lenders, looks to the market for loans to debtors of comparable risk.[80] More specifically, courts would look at the interest rates "the creditor could have obtained if it had foreclosed on the loan, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk."[81]

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[74] *See, e.g.*, Wong, *supra* note 4, at 1944–45 ("The lack of a majority rationale weakens the precedential effect of *Till* in non-Chapter 13 situations, especially because each opinion endorses a different method for determining interest rates.").

[75] *Till*, 541 U.S. at 470.

[76] *Id.* at 471.

[77] Commonly referred to as a "PMSI."

[78] *Till*, 541 U.S. at 471 (citation and internal quotation marks omitted).

[79] *Id.* at 473.

[80] *Id.* at 471.

[81] *Id.* at 472.

Writing for the plurality, Justice Stevens rejected this approach in *Till* because it is "complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value."[82] The plurality also added that this method would require bankruptcy courts to conduct an inquiry far removed from their usual task of "evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans."[83] Finally, Justice Stevens added that this approach would overcompensate creditors as market interest rates include elements of profit, transaction costs, and other factors that are "no longer relevant in the context of court-administered and court-supervised cram down loans."[84]

2. The Presumptive Contract Rate Approach

The presumptive contract rate approach is a "slightly modified version of the [coerced loan approach]."[85] This method begins with the interest rate on a debtor's initial loan.[86] Recognizing, however, that loans to bankrupt debtors are inherently riskier than loans to non-bankrupt individuals, courts applying the presumptive contract rate approach[87] adjust the contract rate for the actual risks associated with the debtor.[88]

The Supreme Court rejected the presumptive contract rate approach for the same reasons it rejected the coerced loan approach.[89] Additionally, it noted that rebutting the contract rate in order to move the discount rate downward would be extremely burdensome on debtors seeking to "reduc[e] the likelihood that creditors will be substantially overcompensated."[90] Finally, the Court emphasized the inconsistencies in creditor treatment that may result from this method[91]: "because the approach relies heavily on a creditor's prior dealings with the debtor, similarly situated creditors may end up with vastly different

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[82]   *Id.* at 477.

[83]   *Id.*

[84]   *Till*, 541 U.S. at 477.

[85]   *Id.* at 472.

[86]   *Id.*

[87]   Before *Till* made its way up to the Supreme Court, the Seventh Circuit adopted this approach and remanded the case to the bankruptcy court in order to come up with the appropriate adjustment to the contract rate of twenty-one percent. *Id.*

[88]   *Id.* at 473.

[89]   *Id.* at 477.

[90]   *Till*, 541 U.S. at 477.

[91]   *Id.* at 478.

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cram down rates."[92]

3.   The Cost of Funds Approach

This method of cramdown rate determination asks: "what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source."[93] The Supreme Court rejected this approach as it "mistakenly focuses on the creditworthiness of the *creditor* rather than the debtor" and increases the debtor's overall evidentiary burden.[94]

4.   The Formula Approach

The Court finally settled on the method advocated for by the debtors—the formula approach. The formula approach starts with the risk-free rate and adjusts upward based on the risk of non-payment.[95] The Court accepted this method for a number of reasons.[96] First, by starting with a lower rate and adjusting upward, the burden lies "squarely [with] the creditors, who are likely to have readier access to any information absent from the debtor's filing."[97] Additionally, the evidentiary costs are minimal as the debtors' bankruptcy papers, on record with the Court, contain a significant amount of information on the debtors' post-confirmation credit risk.[98] Unlike the previous three approaches, "the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings."[99] Finally, Justice Stevens added that the formula approach "best comports with the purposes of the Bankruptcy Code" as it depends on "the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor."[100] The plurality further emphasized that the policy behind the cramdown rate is to "*ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default.*"[101] In fact, both the

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[92]   *Id.*

[93]   *Id.* at 473 (quoting *In re* Till, 301 F.3d 583, 595–96 (7th Cir. 2002)).

[94]   *Id.* at 478.

[95]   Courts generally use the prime rate or treasury yield of comparable duration to a debtor's loan. *See id.* at 478–79.

[96]   *Till,* 541 U.S. at 479.

[97]   *Id.*

[98]   *Id.*

[99]   *Id.*

[100]   *Id.*

[101]   *Id.* at 477 (emphasis added).

plurality and the dissent agreed with this initial premise;[102] their only disagreement was over "which procedure will more often produce accurate estimates of the appropriate interest rate."[103]

B. *Post-Till Cases Dealing with Cramdown Interest Rate Determination in the Chapter 11 Context*

Since *Till* was decided, federal courts remain divided with regard to its applicability in chapter 11. The cases that follow serve to illustrate the competing approaches of bankruptcy courts around the country.

1. *Momentive*

In 2006, MPM Silicones ("Momentive") was taken private through a leveraged buyout (LBO) by prominent financial sponsor Apollo Global Management ("Apollo").[104] In order to finance the transaction, Apollo saddled Momentive with a substantial amount of debt.[105] In 2012, Momentive issued first and 1.5 lien notes pursuant to an indenture that provided for 8.875% and 10% interest rates respectively (collectively, the "Senior Lien Notes").[106] As is often the case with LBOs, the target company failed in part due to its highly leveraged capital structure.[107] In April 2014, Momentive filed for bankruptcy and proposed a plan that would eliminate more than three billion dollars in debt.[108] Momentive's plan was structured with a "death trap" provision: it proposed that "all outstanding principal and accrued interest on the Senior Lien Notes would be paid in cash to the Senior Lien Notes on the effective date of the Plan."[109] This payment would not, however, provide for any sort of "make-whole" premium to the Senior Lien Noteholders.[110] If the Senior Lien Noteholders refused the terms of the

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[102]   *Till*, 541 U.S. at 491 (Scalia, J., dissenting).

[103]   *Id.*

[104]   Sara Randazzo, *Judge Approves Momentive's Bankruptcy Exit Plan* (Sept. 12, 2014, 3:01 PM), http://online.wsj.com/articles/judge-approves-momentive-bankruptcy-exit-plan-1410548507.

[105]   *Id.*

[106]   U.S. Bank. N.A. v. Wilmington Sav. Fund Soc'y (*In re* MPM Silicones, LLC), 531 B.R. 321, 325 (S.D.N.Y. 2015).

[107]   Randazzo, *supra* note 104.

[108]   *Id.*

[109]   *In re MPM Silicones, LLC*, 531 B.R. at 326.

[110]   *Id.* When a creditor refinances its debt on the open market, the "make-whole" call premium is designed to compensate the noteholder for the foregone coupon payments it would have received between the call date and maturity date. *See* LUBBEN, *supra* note 52, at 197. Whether or not payment in bankruptcy triggers the make-whole is an issue of contract interpretation.

consensual plan, Momentive proposed to cram them down with re-placement notes "with a *present value equal to the Allowed amount of any such holder's Claim.*"[111] Because Momentive failed to meet the voting requirements of Section 1129(a)(8), the plan had to proceed under Section 1129(b).[112]

Interest rate determination was one of the many contested issues at Momentive's confirmation hearing.[113] Momentive's Senior Lien Noteholders objected on the grounds that their deferred payments under the plan failed to meet the requirements of Section 1129(b)(2)(A)(ii).[114] More specifically, they alleged that they were entitled to a higher discount rate than the one proposed under the plan—seven-year treasury plus 1.5%, or approximately 3.6%.[115] Like the lenders in *Till*, the Senior Lien Noteholders asserted that the coerced loan approach—not the formula approach used by the debtors—was best-suited.[116] They argued that *Till* is only binding in chapter 13 cases and thus was not relevant for Section 1129(b)(2)(A)(ii) considerations. In holding that Section 1129(b)(2)(A)(ii) mandates the use of the formula approach, Judge Drain began by noting that "there is no sufficiently contrary basis to distinguish the chapter 13 and chapter 11 plan contexts in light of the similarity of the language of the two provisions and the underlying present value concept that *Till* recognized should be applied uniformly throughout the Code."[117] Stating that the same policy concerns that had led the Supreme Court to accept the formula approach in *Till* are equally relevant in chapter 11, the court concluded that the indenture trustee had provided no basis for its claim that it must be put in "in the same position that it would have been in had it arranged a 'new' loan."[118] The court affirmed Justice Stevens' rationale in *Till* that the cramdown rate analysis should not take into account factors such as "transaction costs and overall profits."[119] Rather, the purpose of Section 1129(b)(2)(A)(ii) is simply to ensure that the present value of the deferred cash payments ("C")

[111] *In re MPM Silicones, LLC*, 531 B.R. at 326 (emphasis added).

[112] *Id.*

[113] *In re* MPM Silicones, LLC, No. 14-22503-rdd, 2014 Bankr. LEXIS 3926, at *70 (Bankr. S.D.N.Y. Sept. 9, 2014).

[114] *Id.* Notably, Judge Drain also determined that the language of the first and 1.5 lien indentures did not entitle the noteholders to the make-whole premium. *See generally* Lubben, *supra* note 14.

[115] *In re MPM Silicones*, 2014 Bankr. LEXIS 3926, at *70–71.

[116] *Id.* at *71.

[117] *Id.* at *72–73.

[118] *Id.* at *75.

[119] *Id.* (quoting Till v. SCS Credit Corp., 541 U.S. 465, 477–78 (2004)).

is equal to that of the allowed secured claim.[120]

Notwithstanding the policy concerns addressed above, the secured lenders in *Momentive* put forth an additional argument based on a footnote from *Till*.[121] In footnote 14, Justice Stevens suggested that a coerced loan approach might work in chapter 11 if a bankruptcy court can determine that an efficient market exists for such loans. Footnote 14 states:

> Because every cram down loan [in chapter 13] is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession.[122]

Justice Stevens went on to note that in chapter 11, "it might make sense to ask what rate an efficient market would produce."[123] The secured lenders in *Momentive* argued that footnote 14 required a coerced loan approach in chapter 11 on the ground that the interest rates charged by the debtor's bridge lenders and exit facility financiers were efficient.[124] They argued that these rates should be used as proxies for the plan payments.[125] Had the Senior Lien Noteholders accepted the terms of the original plan, their notes would have been refinanced via exit facilities that provided for a five percent interest rate for the first lien exit lenders and a seven percent interest rate for the 1.5 lien lenders.[126] Accordingly, they proposed that these rates should be used instead of the 3.6% and 4.1% rates offered under the plan.[127]

Rejecting the creditors' argument, the court in *Momentive* pointed out a significant flaw in footnote 14. The court emphasized that Justice Stevens was referring to *DIP financing* and not *exit financing* when he stated that numerous lenders advertise to chapter 11 debtors in possession.[128] DIP financing occurs at the beginning of a case, and lenders obtain special priority status under a plan.[129] Exit financing, on the other hand, occurs at confirmation.[130] Because chapter 11 plans often

[120]   *Id.*
[121]   *In re MPM Silicones*, 2014 Bankr. LEXIS 3926, at *78.
[122]   *Till*, 541 U.S. at 476 n.14.
[123]   *Id.*
[124]   *See In re MPM Silicones*, 2014 Bankr. LEXIS 3926, at *74–79.
[125]   *Id.* at *74.
[126]   *Id.* at *87.
[127]   *Id.* at *74.
[128]   *Id.* at *81.
[129]   *Id.*
[130]   *See In re MPM Silicones*, 2014 Bankr. LEXIS 3926, at *81.

shave substantial amounts of debt from the books of a debtor, creditors at confirmation are presented "with a less risky, more stable and re-structured debtor."[131] This partially eliminates the need to compensate the creditor with the higher yields that DIP loans provide. With this in mind, the court emphasized that the market for exit financing in chapter 11 is not a robust one and that the claim that such a market is efficient is dubious at best.[132] As a result, the court held that the Senior Lien Noteholders were not entitled to the rates offered by the exit lenders. "In this case, for example, the evidence shows that there were only three available exit lenders to the debtors, who eventually combined on proposed backup takeout facilities while seeking to keep confidential their fees and rate flex provisions."[133] The court ultimately concluded that footnote 14 should be read narrowly as not to restrict *Till*'s applicability to chapter 11 bankruptcies and set the replacement notes' interest rates at 4.1% and 4.85%.[134] Many other courts across the country have reached this same conclusion.[135]

2. *Till*'s Footnote 14 and the Two-Stepped Approach

Other federal courts have held that a market-based approach may be used to determinate the rate of interest on a cramdown loan in chapter 11 if a trial court can determine that an efficient market for comparable loans exists. In *American HomePatient*, the United States Court of Appeals for the Sixth Circuit endorsed a two-step approach for determining the discount rate in a chapter 11 cramdown.[136] Relying primarily on footnote 14, the Sixth Circuit determined that bankruptcy courts should first look to the market for loans to businesses financially comparable to the DIP.[137] If the lender can demonstrate that the market is efficient, these rates should be used as proxies for plan payments.[138] Otherwise, courts should apply the formula approach.[139] Apart from *American HomePatient*, other courts have adopted this two-

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[131]   *Id.*

[132]   *See id.* at *82.

[133]   *Id.* at *83.

[134]   *Id.* at *98–99.

[135]   *See id.* at *89 (citing *In re* SW Boston Hotel Venture, LLC, 460 B.R. 38 (Bankr. D. Mass. 2011); *In re* Marfin Ready Mix Corp., 220 B.R. 148, 158 (Bankr. E.D.N.Y. 1998); *In re* Vill. at Camp Bowie I L.P., 454 B.R. 702, 712–13 (Bankr. N.D. Tex. 2011); *In re* Lilo Props., LLC, 2011 Bankr. LEXIS 4407, at *3–6 (Bankr. D. Vt. Nov. 4, 2011)).

[136]   Bank of Montreal v. Official Comm. of Unsecured Creditors (*In re* Am. HomePatient, Inc.), 420 F.3d 559, 568 (6th Cir. 2005), *cert. denied*, 549 U.S. 942 (2006).

[137]   *Id.*

[138]   *Id.*

[139]   *Id.*

part test as well.[140]   These courts seem to emphasize one common theme: as to chapter 11, *Till* is instructive but not binding.[141]   As the court in *American HomePatient* noted:

> [The Sixth Circuit] decline[s] to blindly adopt *Till*'s endorsement of the formula approach [in Chapter 11] . . . . Rather, we opt to take our cue from Footnote 14 of the opinion, which offer[s] the guiding principle that "when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."[142]

In spite of the guidance of *Till* footnote 14 and *American HomePatient*, the standard for determining whether a market for loans is efficient remains highly ambiguous. In fact, often times, courts adopting the two-stepped methodology of *American HomePatient* end up using the formula approach when the parties fail to present any sort of efficient markets evidence altogether.[143]   Nonetheless, there are a few reported decisions describing how courts address the question of market efficiency.

3. Current Market Efficiency Standards for Cramdown Rate Determination

One example of an opinion explaining how an efficient market analysis should work is *In re 20 Bayard Views, LLC*.[144]   In *Bayard Views*, the debtor, a condominium developer, proposed a cramdown plan over the objection of W Financial Fund LP (WFF), the debtor's primary secured lender.[145]   The court decided to follow the two-step approach for rate determination endorsed in *American HomePatient*.[146]

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[140]   *See In re MPM Sillicones*, 2014 Bankr. LEXIS 3926, at *74 (citing Mercury Capital Corp. v. Milford Conn. Assocs., L.P., 354 B.R. 1, 11–12 (Bankr. D. Conn. 2006); *In re* Cantwell, 336 B.R. 688, 692–93 (Bankr. D.N.J. 2006); *In re* 20 Bayard Views LLC, 445 B.R. 83 (Bankr. E.D.N.Y. 2011)).

[141]   *In re Am. HomePatient, Inc.*, 420 F.3d at 568.

[142]   *Id.* (citing Till v. SCS Credit Corp., 541 U.S. 465, 476 n.14 (2004)).

[143]   *See, e.g.,* Wells Fargo Bank N.A. v. Tex. Grand. Prairie Hotel Realty, L.L.C. (*In re* Tex. Grand. Prairie Hotel Realty, L.L.C.)*,* 710 F.3d 324, 333 (5th Cir. 2013) ("While courts often acknowledge that *Till*'s Footnote 14 appears to endorse a 'market rate' approach under Chapter 11 *if* an 'efficient market' for a loan substantially identical to the cramdown loan exists, courts almost invariably conclude that such markets are absent.") (emphasis added); *In re* Cantwell, 336 B.R. 688, 693 (Bankr. D.N.J. 2006) ("Here, there has been no evidence produced to establish that an 'efficient market' exists to refinance the mortgages on the debtors' property immediately, as the debtors are emerging from their Chapter 11 case. We therefore [apply the formula approach].").

[144]   445 B.R. 83 (Bankr. E.D.N.Y. 2011).

[145]   *Id.* at 88.

[146]   *Id.* at 109.

Advocating for a coerced loan rate,[147] WFF presented expert testimony on the existence of a loan market for similar condominium developers.[148] The court determined that the analysis should begin with an inquiry into whether other creditors are willing to lend to companies similar to the debtor.[149] Such a market is deemed "efficient" if these creditors are willing to lend on terms similar to those of the replacement notes under the plan.[150] The court noted that some other courts examine "whether the debtor can obtain a loan through a combination of different tranches of financing."[151]

At trial, the debtor presented evidence indicating that local lenders had no interest in issuing loans to similar real estate developers.[152] The creditors put forth evidence demonstrating that local lenders would be willing to finance companies similar to the debtor-in-possession via a three-tiered capital structure consisting of first lien debt, mezzanine financing, and equity.[153] WFF's expert witness testified that the average cost of capital associated with this financing structure amounted to approximately 11.68%—a figure greater than the discount rate proposed under the plan.[154]

The court ultimately concluded that "an efficient market does not exist for a loan of this size secured by collateral of this nature in the full amount of the value of the [p]roperty," and "participants in the loan market were not willing to make a loan of the nature proposed in the [p]lan."[155] The court ironically relied on WFF's expert's own admission that no creditors would be willing to lend on a 100% loan-to-value basis as the relevant condominium financing market perceives

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[147]   *Id.* at 106 ("SCS objected to confirmation of the plan, arguing that 21 percent was the appropriate interest rate because that was the rate it would have received if it had foreclosed on the truck and reinvested the proceeds in loans of similar duration and risk.").

[148]   *Id.* at 110.

[149]   *Id.* at 109.

[150]   *See In re 20 Bayard Views*, 445 B.R. at 109 (citing *In re* One Times Square Assocs. Ltd. P'ship, 159 B.R. 695, 706 (Bankr. S.D.N.Y. 1993)).

[151]   *Id.*

[152]   *Id.* at 110. The debtor's third amended plan of reorganization ("the plan") called for WFF to retain the liens on its secured claim of approximately eighteen million dollars as well as to receive new liens on any "leases related to the condominium storage units." *Id.* at 91. Additionally, the debtor proposed to make 4.5% monthly interest payments on the face value of WFF's claim in addition to accelerating annual principal payments over a five-year period. *Id.* at 88.

[153]   *Id.* at 110.

[154]   *Id.*

[155]   *Id.*

the risk associated with such leverage to be too high.[156] Since the creditor failed to meet its burden in establishing an "efficient market," the court next applied the formula approach and determined that the 1.5% risk premium did not adequately reflect the likelihood of a declining equity cushion in the collateral and the possibility of the plan's failing.[157]

Although *Bayard Views* failed to ultimately apply the coerced loan approach, it demonstrates, in detail, the factors that courts consider when determining whether a market for coerced lines is "efficient." Other courts and commentators have considered slightly modified approaches.[158] Part V.B. will analyze whether this type of analysis truly comports with the policy behind *Till* and footnote 14 and will discuss why this method is inconsistent with the Supreme Court's definition of "market efficiency."

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[156] *In re 20 Bayard Views*, 445 B.R. at 111.

[157] *Id.* at 113.

[158] *See, e.g.*, *In re* Winn-Dixie Stores, 356 B.R. 239, 56 (Bankr. M.D. Fla. 2006) ("Debtor's search resulted in fourteen proposals among competing lending institutions for a loan that would be junior to the Class 10 Claimants' liens. The result of that search was an interest rate of LIBOR plus 150 points. The Court finds that the process leading to the exit facility was an efficient test of the market."); *In re* S. Canaan Cellular Invs., 427 B.R. 44, 78 n.21 (Bankr. E.D. Pa. 2010) ("Determination of whether that market exists requires evidence of loans similar in time of repayment, amount to be repaid, quality of collateral, and risk of repayment owing to the financial condition of the borrower."); Gen. Elec. Credit Equities, Inc. v. Brice Rd. Devs., L.L.C. (*In re* Brice Rd. Devs., L.L.C.), 392 B.R. 274, 280–81 (6th Cir. B.A.P. 2008) (noting that in determining whether a comparable loan market is efficient, courts may consider "the priority of the lien securing the loan; whether there exists an open, well-developed market for loans of the kind between the debtor and secured creditor; the type of collateral involved; the quality, age, and life expectancy of the collateral; the proposed short- or long- term nature of the loan; and the amount financed"); Louis E. Robichaux IV et al., Till *in Chapter 11 Cases and the Looming "Efficient Market" Debate*, AM. BANKR. INST., July 2013, at 22, 24 (proposing that in conducting an efficient markets analysis, expert witnesses consider the general macroeconomic environment, capital markets metrics, the debtor's industry, and "current underwriting parameters in the loan market that sufficiently matches the cramdown loan," such as "prevailing interest rates, lien priority, loan-to-value ratio, and debt service coverage or debt-to-EBITDA ratio").

V. WHY THE FORMULA APPROACH SHOULD BE USED IN CHAPTER 11: *TILL* AND THE EFFICIENT CAPITAL MARKETS HYPOTHESIS BOTH NECESSITATE SUCH A RESULT

The holding in *American HomePatient* subjects itself to criticism for a number of reasons. First, as articulated in *Momentive*, any attempt to justify the use of a coerced rate approach in chapter 11 is inconsistent with the overriding policy concerns of the Code outlined in *Till.* Second, the type of efficient market analysis contemplated by courts that declined to follow *Till* is inconsistent with the Supreme Court's notion of market efficiency as it erroneously equates the concept of a robust market with an efficient market.[159] The parts of this Comment that follow discuss why all of these concerns provide support for the use of *Till*'s formula approach in chapter 11.

A. *Till's Applicability in Chapter 11: Cost-Savings and Public Policy Justifications*

Economic considerations, *stare decisis,* and public policy all strongly favor *Till*'s application to all chapters of the Code. Such considerations should encourage courts to apply a non-market-based approach in chapter 11.

One important consideration for interpreting the Bankruptcy Code is how a particular reading of the language of the statute will impact the economics of the estate and the courts. Unanticipated post-petition fees and expenses can be detrimental to the debtor's business. The evidentiary costs of a hearing on the efficiency of the market for comparable loans create another obstacle for a DIP attempting to get a plan confirmed. More financial resources are drained, and the likelihood of the debtor's emergence from bankruptcy decreases. The Supreme Court emphasized the importance of minimizing these costs in rejecting the coerced loan and cost of funds approach. "[T]he cost of funds approach *imposes a significant evidentiary burden, as a debtor seeking to rebut a creditor's asserted cost of borrowing must introduce expert testimony about the creditor's financial condition.*"[160] As stated by the *Momentive* court, these policy concerns are equally relevant in chapter 11. Proffering expert testimony is a costly and time-consuming process that may ultimately serve as a detriment to successful business reorganization. Indeed one commentator has emphasized how problematic this

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[159]   *See, e.g.,* Simkovic & Kaminetzky, *supra* note 20, at 157 ("The Supreme Court has long embraced the belief, widely shared by many Anglo-American economists, that well-regulated financial markets effectively process available information and thereby fairly and appropriately value securities.").

[160]   Till v. SCS Credit Corp., 541 U.S. 465, 478 (2004) (emphasis added).

burden can be, noting that "[a]s the credit crisis worsens and DIP lending becomes scarce, it will become increasingly problematic to require chapter 11 debtors to adduce evidence of a market rate, let alone an efficient market rate during a recession."[161] The incremental evidentiary costs associated with the formula approach, however, are minimal as the bankruptcy court already has the necessary information at hand for determining the applicable risk premium.[162] Bankruptcy courts routinely examine the factors used to arrive at such a premium when determining the feasibility of a plan under Section 1129(a)(11).[163] Some of these factors may include "[the] debtor's industry, projections, leverage, revised capital structure, and obligations under the plan."[164] Because these factors are always taken into consideration in any Section 1129(a)(11) analysis, the formula approach will save the court both time and resources. The formula approach therefore reduces the overall burdens associated with chapter 11, both from debtor and judicial perspectives, and increases the likelihood of the debtor's successful emergence from bankruptcy.

The doctrine of *stare decisis* is also particularly relevant in corporate restructuring jurisprudence. Consistent legal standards play an important role in determining the likelihood that a distressed business will emerge from bankruptcy.[165] As the "interests of predictability in commercial bankruptcy cases are of such great importance,"[166] courts should adopt a cramdown rate approach that yields consistent and predictable results. The range of potential outcomes from the coerced loan approach is vast and imposes a significant level of uncertainty on

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[161] Pill, *supra* note 4, at 298–99.

[162] *Till*, 541 U.S. at 479 (stating that the court must start with the appropriate risk-free rate and "adjust the [rate] accordingly" based on factors such as "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan").

[163] *See* 11 U.S.C. § 1129(a)(11) (2012) ("Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan."). Commonly known as the "feasibility test," a debtor satisfies this test through expert testimony on the company's operations, financial statements and projections, general economic conditions and systemic risk, and proffers demonstrating the risk associated with plan confirmation.

[164] *See generally* AM. BANKR. INST. COMM'N TO STUDY THE REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 234–37 (2012), http://commission.abi.org/full-report.

[165] *See In re* GMC, 407 B.R. 463, 504 (Bankr. S.D.N.Y. 2009) ("[S]tare decisis is particularly important in commercial bankruptcy cases because of the expense and trauma of any commercial bankruptcy, and the need to deal with foreseeable events, by pre-bankruptcy planning, to the extent they can be addressed.").

[166] *Id.*

the debtor. The magnitude of this variation can amount to millions of extra dollars in unanticipated interest payments.[167] The risk premium associated with the formula approach, however, tends to be lower and more stable since a bankruptcy judge cannot confirm a plan unless it "is not likely to be followed by the liquidation, or the need for further financial reorganization" unless disclosed.[168] Such a conclusion inherently necessitates a relatively low *and* predictable risk-premium under the formula approach. By using the formula approach, courts can therefore eliminate some of the uncertainty associated with the wide range of possible outcomes under the coerced loan approach.

Public policy considerations also play a significant role when analyzing any statute. The policy argument against applying the formula approach appears to be predicated upon two themes: (1) the desire to protect a creditor's pre-petition expectations; and (2) the inherent differences between a consumer debtor and a business debtor.[169] The former stems from the concern that the cramdown rate might be significantly smaller than the original contract rate and will therefore undermine the lender's initial expectations. The probability of a bankruptcy filing, however, is generally contemplated when executing a credit agreement. A "default" under the agreement is often defined to include a bankruptcy filing, and the debt immediately accelerates. When this occurs, there is often a significant time delay between the filing and the distributions under the plan. Moreover, in the case of a sale of the debtor's assets, such sale may yield insufficient proceeds to cover the lender's claim, and the creditor is forced to take a substantial loss. In sum, a bankruptcy petition inherently triggers numerous uncertainties, and the Code expressly contemplates multiple scenarios where a creditor's expectations may be undermined. With respect to the second concern, while it is true that the policies underlying a consumer bankruptcy and business reorganization differ in many respects, Congress explicitly codified numerous provisions that reflect these concerns. That Congress chose to use virtually identical language in the relevant chapter 11 and chapter 13 provisions suggests that it did not intend for the cramdown rate analysis to differ in the two contexts. "[T]here is no sufficiently contrary basis to distinguish the chapter 13 and chapter 11 plan contexts in light of the *similarity of the language of the two provisions and the underlying present value concept that Till recognized*

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[167] *See generally* GMAC v. Valenti (*In re* Valenti), 105 F.3d 55, 64 (2d Cir. 1997) (noting the wide range of risk-premiums applied by courts in the consumer cramdown settings).

[168] 11 U.S.C. § 1129(a)(11).

[169] *See, e.g.*, Wong, *supra* note 4, at 1954–56.

should be applied uniformly throughout the Code."[170] Major American financial institutions may contain both consumer and corporate financing arms, and it makes little sense to suggest that businesses loans and corporate loans should be treated differently in this context.

The strength of the policy justifications behind applying the formula approach and the flaws of the arguments against its applicability in chapter 11 combine to favor a broad reading of *Till* that incorporates its holding to chapter 11. These policy considerations should deter courts confronted with chapter 11 cramdown plans from reading *Till* footnote 14 in "a way contrary to *Till* and *Valenti*'s first principles."[171] The principles articulated in these cases are straightforward and equally applicable in chapter 13 and chapter 11: the proper interest rate should set the present value of a note's future cash flows equal to the amount of the allowed secured claim when discounted by the correct yield. Although *Till* is often discounted because it is a plurality opinion, even the dissenting four Justices concurred with this fundamental principle.[172] As discussed in Part III, factors such as the firm's risk of nonpayment, the duration of the note, inflation, and the value of the collateral will yield a rate that will balance the equation in Figure 6. For the aforementioned reasons, a non-market-based approach is a more efficient method of achieving this objective from a policy perspective.

The above notwithstanding, it should be noted that the American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11 (the "Commission") recently suggested that Congress should reject *Till*'s applicability to chapter 11 cases.[173] In fact, the Commission went a step further than the Sixth Circuit in *American HomePatient* in arguing that the formula approach is inappropriate in chapter 11 "even if an efficient market does not exist."[174] Nonetheless, the Com-

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[170] *In re* MPM Silicones, LLC, No. 14-22503-rdd, 2014 Bankr. LEXIS 3926, at *72–73 (Bankr. S.D.N.Y. Sept. 9, 2014) (emphasis added).

[171] *Id.* at *84.

[172] Till v. SCS Credit Corp., 541 U.S. 465, 508 (2004) (Scalia, J., dissenting) ("Eight justices are in agreement that the rate of interest set forth in the debtor's approved plan must include a premium for risk. Of those eight, four are of the view that beginning with the contract rate would most accurately reflect the actual risk, and four are of the view that beginning with the prime lending rate would do so."); *see also In re* Texas Grand Prairie Hotel, 710 F.3d 324, 330 (5th Cir. 2013) ("In other words, the deferred payments, discounted to present value by applying the appropriate interest rate . . . must equal the allowed amount of the secured creditor's claim.").

[173] AM. BANK. INS. COMM'N TO STUDY THE REFORM OF CHAPTER 11, *supra* note 164, at 234–37.

[174] *Id.* at 237.

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mission did not address in detail why the overarching policy goals described in *Till* should apply only in chapter 13.[175] Furthermore, the Commission asserted that the formula approach fails to capture the economic realities of the restructured debtor.[176] It is unclear, however, why the Commission takes this position when the formula approach, by its very definition, attempts to capture the underlying variables associated with the firm's credit risk. Additionally, the Commission states that if a market rate cannot be determined, courts should consider a "risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor considering factors such as the debtor's industry, projections, leverage, revised capital structure, and obligations under the plan."[177] These are some of the factors that should be inherent in any interest rate calculation.[178]

Further, the Commission's argument that the formula rate likely undercompensates the creditor for the risk associated with the post-confirmation debtor may suggest that the debtor should not have even passed the feasibility test in the first place. Since Section 1129(a)(11) requires courts to determine that confirmation of the plan is not "likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan," such a determination may be tantamount to a finding that the securities issued under the plan do not carry enough risk to warrant a substantial premium over the treasury or prime rate.[179] Additionally, the Commission acknowledges that it did not try to decipher the holding in *Till.*[180] Nonetheless, because the *Till* case is the closest indicator of where the Supreme Court may stand on this issue, it makes sense to scrutinize footnote 14, at least before Congress formally considers the Commission's proposals.

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[175]   *Id.*

[176]   *Id.*

[177]   *Id.*

[178]   *See, e.g., In re* Texas Grand Prairie Hotel, 710 F.3d 324, 334 (5th Cir. 2013) (noting that the risk premium should factor in "the quality of the debtor's management, the commitment of the debtor's owners, the health and future prospects of the debtor's business, the quality of the lenders collateral, and the feasibility and duration of the plan").

[179]   *See In re* MPM Silicones, No. 14-22503-rdd, 2014 Bankr. LEXIS 3926, at *81 (Bankr. S.D.N.Y. Sept. 9, 2014) ("The fact that the debtor is more stable is bound up in the court's necessary feasibility determination under Section 1129(a)(11)."). *See also* Till v. SCS Credit Corp., 541 U.S. 465, 480–81 ("If the court determines that the likelihood of default is so high as to necessitate an 'eye-popping' interest rate . . . the [chapter 13] plan probably should not be confirmed.") (citations omitted).

[180]   AM. BANKR. INST. COMM'N TO STUDY THE REFORM OF CHAPTER 11, *supra* note 164, at 234–37.

B. *Financial Considerations: Reconciling the Different Standards for Determining Market Efficiency and the Potential Pitfalls of the Footnote 14 Analysis*

In spite of the compelling public policy reasons for using the formula approach discussed above, many courts have rejected this line of reasoning. Courts that have done so often base their decisions upon *Till* footnote 14. As the wording of this footnote is highly convoluted and contains numerous technical ambiguities, an examination of what the Supreme Court might have intended is crucial before taking footnote 14's directive.

At first glance, footnote 14 appears to suggest that DIP loans might serve as accurate proxies for cramdown rates. For the reasons stated above, however, most bankruptcy practitioners acknowledge that this was a technical error on Justice Stevens' part. As a result, courts that disapprove of the *per se* use of the formula approach in chapter 11 have modified the analysis to find that footnote 14 allows parties to "ask what [non-DIP loan] rate an efficient market would produce"[181] before determining whether the formula approach or coerced loan approach should be used in a chapter 11 case. But what exactly does Justice Stevens mean by "efficient market?" As discussed *supra*, courts have interpreted footnote 14 in a way that allows creditors to receive a coerced loan rate if they can show that a robust market exists for loans to entities similar to the debtor (what these courts call an "efficient market").[182] Indeed, this was the test that *American HomePatient* and *20 Bayard Views* endorsed.[183] When carefully scrutinizing this footnote, however, reasonable minds can differ as to whether an abundance of lenders is the sole criterion for what the Supreme Court deems an "efficient market."[184] After all, if Justice Stevens had truly believed that the existence of an abundance of lenders to similar debtors was the only factor in ascertaining the reliability of market rates, why did he not accept the creditor's argument in *Till*? The secured lender in that case was able to demonstrate the existence of a robust

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[181]   *Till*, 541 U.S. at 476 n.14.

[182]   *See supra* Part IV.B.3.

[183]   *Id.*

[184]   *See, e.g.*, *A Deep Dive into* Till v. SCS Credit Corp—*Part VII: How to Understand Footnote 14,* THE NECESSARY AND PROPER BLOG, (Jan. 3, 2014, 4:30 PM), http://thenecessaryandproperblog.blogspot.com/2014/01/a-deep-dive-into-till-v-scs-credit-corp_2837.html (arguing that courts have misinterpreted the meaning of footnote 14 and have overemphasized its precedential value in chapter 11); Pill, *supra* note 4, at 291–92 ("In *Till*, the Court referenced in dicta a 'free market of willing lenders' but did not establish whether the availability of DIP lending singularly would establish the presence of a market.").

primary market for subprime automobile lending (as noted by Judge Drain in *Momentive*). Nonetheless, Justice Stevens still refused to allow the creditors to discount the plan payments at this rate and implied that such a characteristic of a market was not indicative of its efficiency. Moreover, he made it clear that the purpose of the cramdown rate is solely to ensure that the present value of the creditor's future cash flows under the plan equaled the amount of its allowed secured claim. Allowing a secured lender to receive the equivalent of what it could receive if it were to foreclose on the collateral and invest the proceeds in such "efficient" debt instruments seems to contradict this policy concern. As stated above, Justice Stevens offered no justification for why this concern should not apply in chapter 11, and the dissent appeared to concur with this principle. Finally, and perhaps most importantly, why would the Court redefine the term "efficient market" without explaining the new definition in this context when it has a well-established legal definition that has laid the foundation for numerous Supreme Court opinions and serves as the basis for the federal securities laws? In sum, many of these suggested interpretations of footnote 14 contain significant flaws, and it is therefore necessary to look at the footnote from different angles.[185]

As footnote 14 is both ambiguous and prone to criticism from a bankruptcy practitioner's perspective, prior Supreme Court cases may be consulted to get a better idea of the true meaning of the term "efficient markets."[186] The seminal case on this issue, *Basic Inc. v. Levinson*, provides some useful guidance.[187] A major question before the Supreme Court in *Basic Inc.* was whether a corporation's false statements denying that it was in merger negotiations, which induced a shareholder to sell artificially depressed shares of the defendant's stock, can be deemed "material" in a securities fraud claim.[188] In order to plead

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[185]   *See* Wong, *supra* note 4, at 1953–54 ("The plurality did suggest that an efficient market analysis should apply to Chapter 11 cramdowns, but it failed to provide a workable definition of efficient market."). *But see A Deep Dive into* Till v. SCS Credit Corp— *Part VII: How to Understand Footnote 14*, *supra* note 184 (arguing that the footnote refers to a colloquy in oral argument and should not be relied on in chapter 11).

[186]   For an alternative perspective arguing that the "efficient market comment" in footnote 14 simply refers to usury laws in consumer lending, see Thompson & McDonough, *supra* note 4, at 913–14 (asserting that the footnote referenced a specific colloquy from oral argument and should not be interpreted as having any significant precedential value in the chapter 11 context).

[187]   Basic Inc. v. Levinson, 485 U.S. 224 (1988); *see also* Wong, *supra* note 4, at 1948 ("Although *Till* did not define the term 'efficient market,' the term has appeared quite frequently in other areas of law, especially securities litigation.").

[188]   *Basic Inc.*, 485 U.S. at 227–35.

a securities fraud claim, a plaintiff must show the element of reliance.[189] More specifically, the court addressed the question of whether a plaintiff in a Rule 10b-5 action is entitled to a presumption of reliance on the theory that, in a non-face-to-face transaction, he relied on the market price of the security in ascertaining its actual value.[190] Noting that "[r]ecent empirical studies have tended to confirm Congress' premise that the market *price of shares traded on well-developed markets reflects all publicly available information,* and, hence, any material misrepresentations,"[191] the Court wrote that spreading false information about a corporation undermines an investor's expectation that a security's price should paint an accurate picture of the company—an actionable claim under Securities Exchange Act Rule 10b-5 that the Court deemed the "fraud on the market theory."[192] And those "empirical studies" to which *Basic Inc.* referred, the foundation of the fraud on the market theory, form the basis of what economists call the "Efficient Capital Markets Hypothesis" (ECMH).[193] Indeed, the ECMH is a major driving force behind today's securities laws, and its application in legal matters is widespread. "Of all recent developments in financial economics, the efficient capital market hypothesis ('ECMH') has achieved the widest acceptance by the legal culture."[194]

In spite of the fact that lawyers and judges alike have embraced the ECMH, practitioners often fail to correctly apply its principles in the legal setting. "[T]he legal culture's remarkably rapid and broad acceptance of [the ECMH] is not matched by an equivalent degree of understanding."[195] Such a strong statement invites three important questions. First, how does the ECMH define "efficient markets?" Second, does it make sense that Justice Stevens and the plurality intended for this definition to apply in the cramdown rate context? And finally, are debt markets efficient in the context of distressed debt and loans to companies emerging from chapter 11?

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[189]   5 Alan R. Bromberg & Lewis D. Lowenfels, Bromberg & Lowenfels on Securities Fraud and Commodities Fraud § 7.431 (2d ed. 2004) [hereinafter Bromberg & Lowenfels Treatise].

[190]   *See Basic Inc.*, 485 U.S. at 228.

[191]   *Id.* at 246 (emphasis added).

[192]   *Id.* at 247.

[193]   *Id.* at 253 n.4 (White, J., dissenting).

[194]   *See id.* (quoting Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549–50 (1984)).

[195]   *Id.*

1. The Efficient Capital Markets Hypothesis and its Three Forms

In the broadest terms, the "ECMH [holds] that the prices of securities traded in public capital markets fully reflect all information concerning those securities."[196] This is precisely the foundation of the Supreme Court's holding in *Basic Inc.*[197]

The ECMH posits three distinct types of efficient markets: the weak form, the semi-strong form, and the strong form.[198] Weak form efficiency implies that "current security prices fully reflect all information consisting of past security prices."[199] In other words, security price changes are independent of past price changes—a classic "random walk."[200] Any price change can result only from the production of new information.[201] Semi-strong form efficiency implies that security prices reflect all past and present publicly available information about the underlying company.[202] The strong form of the ECMH holds that all information, both public *and* non-public, is reflected in a security's current price.[203] Under this model, it is impossible for an investor to generate returns in excess of the market index over the long-term as market prices instantaneously incorporate all material public and non-public information.[204] It is important to note that the ECMH does not suggest that positive long-run returns are impossible in an efficient market. Rather, in an efficient market, "it is not possible to find expected returns greater (or less) than the risk-adjusted opportunity cost of capital."[205]

Now that a definition of market efficiency has been established, it makes sense to pause for a moment to consider how this definition is relevant to the footnote 14 analysis. After all, if courts in the chapter 11 context have applied a different definition of efficiency, one may

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[196]   Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546, 559 (1994).

[197]   *See Basic Inc.*, 485 U.S. at 245–46 ("In drafting that [Securities Exchange Act], Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets.").

[198]   Cunningham, *supra* note 196.

[199]   *Id.* at 560.

[200]   S*ee* BREALEY ET AL., *supra* note 55, at 355.

[201]   Cunningham, *supra* note 196, at 560.

[202]   *Id.*

[203]   *Id.*

[204]   *Id.*

[205]   S*ee* BREALEY ET AL., *supra* note 55, at 328.

potentially question the ECMH's relevance.[206] When viewed through the lens of the ECMH, however, the purpose of the market-based approach suggested in *Till* footnote 14 becomes more evident. In the main text of the opinion, the plurality held that the purpose of the cramdown rate was to provide an accurate gauge of the debtor's credit risk and to ensure that the equation in Figure 6 balances. While it did suggest that the coerced loan approach may make sense in chapter 11, it never expressly stated that this policy concern is no longer the driving factor in a chapter 11 cramdown rate analysis.

The ECMH, however, can help to reconcile these two apparently contradictory concerns: comparable market rates may be helpful to the extent that they fully reflect all of the underlying information about the borrower. A market rate that is an accurate reflection of the debtor's risk of default will ensure that the Figure 6 equation balances;[207] if the market is not efficient, the obtained rate may fail to do so, as the coupon "C" may differ significantly from the yield "r." Put another way, a coupon payment that is a function of "the time value of [the secured lender's] money and the risk of default"[208] should equal what that debt instrument would yield in an efficient secondary market. This ensures that the secured lender's claim is paid out at 100 cents on the dollar. As stated above, the expected rate of return on the investment should equal the risk-adjusted opportunity cost of capital and any difference may be indicative of an inefficient market.[209]

The issue of whether market rates fully reflect the information underlying a chapter 11 debtor can be addressed by looking at real-world studies on the validity of the ECMH and the fraud on the market cases involving debt and equity securities. As suggested in *Basic Inc.*, empirical testing has confirmed that semi-strong form efficiency may exist in some equity markets.[210] Moreover, it is possible that the strong

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[206]   Pill, *supra* note 4, at 290 ("While the term 'efficient market' has a commonly used definition in securities litigation, the question remains whether bankruptcy courts will transpose the definition into the bankruptcy arena.").

[207]   LUBBEN, *supra* note 52, at 48 (noting that the proper discount rate should take into account the default risk, inflation risk, and duration risk). *See also* Wong, *supra* note 4, at 1947 ("[A]n efficient market rate of interest may accurately capture the present value of the secured claim, thus fulfilling the fair-and-equitable requirement of the cramdown provisions.").

[208]   Till v. SCS Credit Corp., 541 U.S. 465, 477 (2004).

[209]   *See* Michael Vitti, *Is* Momentive *a Bigger Deal than Typically Reported, or is it Much Ado About Nothing?*, AM. BANKR. INST. J., Apr. 2016, at 40, 109 ("The expected economic profit for a loan issued in an efficient market is (near) zero because the interest will just cover the opportunity cost of capital.").

[210]   *See generally, e.g.*, J. M. Patell & M. A. Wolfson, *The Intraday Speed of Adjustment of Stock Prices to Earnings and Dividend Announcements*, 13 J. FIN. ECON., no. 2, 1984, at 223,

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form of the ECMH may also have some real-world applicability. "[Research on] strong-form efficiency has proved to be sufficiently convincing that many professionally managed funds have given up the pursuit of superior performance. They simply 'buy the index' . . . ."[211] The ECMH, however, remains prone to criticism from both the legal and financial community. Professor James Cox has noted that, "[t]hough [the ECMH] is a cornerstone on which much of securities law has been built, the efficient market hypothesis continues to be surrounded by controversy as scholars from the fields of economics and finance seriously question whether the model fully captures investor behavior . . . or, for that matter, whether the model can ever be validated or discredited."[212] Still, the legal community and the courts accept the notion that, at the bare minimum, semi-strong form efficiency exists in today's equity markets, a notion validated by numerous empirical studies.[213] Despite courts' acceptance of the ECMH in cases involving stock pricing, the case law and financial literature is less clear with regard to debt instruments—precisely the type of securities courts approve in a typical chapter 11 cramdown.[214]

223–52. Semi-strong efficiency is generally tested by examining a security price's reaction time to the disclosure of material information. *Id.*

[211]   BREALEY ET AL., *supra* note 55, at 362; *but see* Cunningham, *supra* note 196, at 561 ("The insider trading scandals of the 1980s are among the many proofs that the strong from of the ECMH is invalid.").

[212]   JAMES D. COX ET AL., SECURITIES REGULATION 96–97 (Wolters Kluwer Law & Business, 7th ed. 2013) (citing R.A. HAUGEN, THE NEW FINANCE: THE CASE AGAINST EFFICIENT MARKETS (1995)); *see also* James Tobin, *On the Efficiency of the Financial System,* LLOYDS BANK REV., July 1984, at 1, https://economicsociologydotorg.
files.wordpress.com/2014/12/tobin-on-the-efficiency-of-the-financial-system.pdf.

[213]   BREALEY ET AL., *supra* note 55, at 362.

[214]   *See, e.g.,* Newby v. Enron Corp. (*In re* Enron Corp. Sec. Derivative & "ERISA" Litig.), 529 F. Supp. 2d 644, 748 (S.D. Tex. 2006) ("[N]o standard at all appears to have been established for measuring market efficiency for debt securities. Adding to that difficulty, thus far there is little scholarly literature about, and only a few courts have addressed, market efficiency for bonds."); *see also* Chris Downing et al., *The Relative Informational Efficiency of Stocks and Bonds: An Intraday Analysis,* J. FIN. & QUANTITATIVE ANALYSIS, Oct. 2009, at 1081, 1081–82 (noting that because the "market for corporate bonds has long been relatively opaque[,] . . . previous studies of the relation between stock and bond returns have drawn conflicting conclusions from dealer quotes of uncertain quality, or narrow datasets that leave the generality of the results open to question").

2. Efficiency of the Markets Relevant to Chapter 11
      Proceedings: Secondary Trading Markets, Small Cap
      Firms, Distressed Firms, and Primary Markets

As described above, "the [ECMH] applies to all types of investment assets."[215] Nonetheless, the hypothesis has been tested primarily on equity markets.[216] "After all, stocks have the most liquid and transparent trading markets, so if the theory applies anywhere, it should apply to stocks."[217] Efforts to improve the transparency of the corporate bond and secured loan markets began in the early 2000s, and, as a result, the topic of credit market efficiency has not been studied as extensively.[218]

Even without numerous conclusive studies to guide their analysis, courts can look at the assumptions behind the ECMH in determining whether a market for a security is efficient. As Professor Lubben noted above, liquidity and transparent trading markets are two key assumptions behind the ECMH.[219] Other assumptions include "a large number of participants such that the actions of any individual participant cannot materially affect the market . . . fully informed [market participants], [participants] have equal access to the market, and act rationally; the commodity is homogeneous; and there are no transaction costs."[220] These assumptions appear to be reasonable with respect to common stocks. The common shares of many public corporations trade on highly centralized exchanges with strict transparency standards.[221] Numerous individuals place trades on these exchanges every

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[215]   LUBBEN, *supra* note 52, at 93.

[216]   *Id.*

[217]   *Id.*

[218]   *See, e.g.*, Chris Downing et al., *supra* note 214, at 1082 ("In recent years, the [National Association of Securities Dealers] has made sweeping reforms of the reporting requirements for over-the-counter corporate bond transactions in an effort to improve the transparency of the market, culminating in the public dissemination of information on most corporate bond transactions."); Cheng Ying, The Informational Efficiency of the Corporate Bond Market (July 2006) (Masters of Science in Finance Thesis) ("Beginning on July 1, 2002, the National Association of Securities Dealers . . . requires all bond dealers to report their transactions through its Trade Reporting and Compliance Engine [TRACE] System.").

[219]   *See* Cunningham, *supra* note 187.

[220]   *See generally id.*; *see also* Wong, *supra* note 4, at 1948 (citing Jonathan R. Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of* Basic v. Levinson, 77 VA. L. REV. 1017, 1022 (1991)).

[221]   *See generally Listed Company Manuel*, NEW YORK STOCK EXCHANGE (Apr. 22, 2016, 10:25 PM), http://nysemanual.nyse.com/LCM/Sections/.

day, and companies are subject to countless information-disclosure requirements under the Securities Exchange Act of 1934.[222] Furthermore, because these companies have such large market capitalizations, it may be difficult for an individual to materially affect the market by himself.[223] District courts have relied upon these assumptions in determining whether the market for a company's common stock is efficient.[224] In *Cammer v. Bloom*, the United States District Court for the District of New Jersey looked at five factors when making this inquiry: (1) trade volume and liquidity; (2) the existence of analyst coverage; (3) the presence of market makers and arbitrageurs; (4) eligibility to participate in the SEC's integrated disclosure procedures; and (5) the stock's responsiveness to new corporate information.[225] Not surprisingly, these "*Cammer* factors" are nothing more than the assumptions behind the ECMH.

While the *Cammer* factors are still relevant in determining whether a market for a company's debt is efficient, a few important distinctions in the analysis are worth nothing. First, courts have stated that the analysis must be conducted "with a view to [bonds'] distinctive nature and to the kinds of news that would move their market price in contrast to the kind of information that might affect the more volatile stock market."[226] Because the primary determinants of a debt instrument's price are the nominal value of the periodic payment "C" and the probability of a default, the underlying information pertaining to the company's financial health (i.e. risk of default) is most relevant in this context.[227] This makes sense since corporate bondholders typically do not stand to benefit from the issuer's potential upside to the same extent

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[222] *See generally* COX ET AL., *supra* note 212, at 9–10 (providing an overview of the Securities Exchange Act of 1934).

[223] For example, as of November 5, 2014, Apple Inc.'s ten largest institutional shareholders own a combined twenty-three percent of the company. Each one of these institutions holds Apple stock in its ETFs and Mutual funds on behalf of thousands of investors worldwide. *See Apple Inc.*, YAHOO! FINANCE, http://finance.yahoo.com/q/mh?s=AAPL+Major+Holders (last visited Nov. 5, 2014, 4:30 PM).

[224] *See, e.g.*, Cammer v. Bloom, 711 F. Supp. 1264 (D.N.J. 1989).

[225] *Id.* at 1286–87. Factor 5, responsiveness to new information, tends to be the method by which economists have empirically validated the semi-strong form of the ECMH. It is also considered the most important factor in the analysis. *See id.* at 1287 ("This, after all, is the essence of an efficient market and the foundation for the fraud on the market theory.").

[226] Newby v. Enron Corp., 529 F. Supp. 2d 644, 749 (S.D. Tex. 2006).

[227] *See id.* at 755–56. *See also* Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market-Theory*, 42 STANFORD L. REV. 1059, 1085 (1990) ("[I]t seems clear that not all corporate information will affect all securities of a given issuer in the same way. Debt securities will be more insulated from the shocks associated with bad news than will equity securities.").

as shareholders. Even in a perfectly efficient market, information that may increase the price of the firm's common stock might have no effect on the firm's bond price.[228] When the likelihood of default increases and the firm approaches insolvency, however, any information pertaining to the firm's value and credit risk can be expected to have a significant impact on the bond's price under the ECMH.[229] Moreover, two variables as opposed to one are relevant: the bond's price and yield. As discussed in Part II, a bond's price and yield are inversely related, and the appropriate question in determining the bond's efficiency is whether or not these two variables accurately capture the information relevant to the default risk. As a result, some courts have noted that the *Cammer* factors are not as helpful in the context of debt securities.[230] Nonetheless, they can provide a court with a threshold indication of a debt instrument's informational efficiency.[231] Accordingly, the relevant inquiry is the degree to which the presence of these factors indicates that the bond/note's price and yield are a function of all material information indicative of the company's default risk (the "Modified *Cammer* factors").

The idea that debt markets exhibit the same degree of efficiency as equity markets has been met with some skepticism from lawyers and economists alike.[232] This makes sense when analyzing the *Cammer* fac-

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[228] *In re* HealthSouth Corp. Secs. Litig., 261 F.R.D. 616, 635–36 (N.D. Ala. 2009) ("Information that may be material to a stock price, such as the announcement of a dividend, may not be material for a bond investor whose fixed return would not be affected. In contrast, the price of bonds may be affected by general, non-company specific information, such as changes in risk-free interest rates, that would not affect stock prices.").

[229] *See* Downing et al., *supra* note 214 ("Because the BBB- and junk-rated bonds are closer to default, the expected cash flows and hence prices of these bonds react to news about the firm's cash flows, albeit at a lag relative to their associated equity owing to the relative inefficiency of the bond market.").

[230] *Id.* at 755.

[231] *Id.* at 752. *See also* Teamsters Local 445 Freight Div. Pension Fund v. Bombardier, Inc., 546 F.3d 196, 210 (2d Cir. 2008) ("We conclude, however, that the district court properly used the *Cammer* factors as an 'analytical tool' [in the debt context].") (quoting Unger v. Amedisys Inc., 401 F.3d 316, 325 (5th Cir. 2005)); *In re* Petrobras Sec. Litig., 14-cv-9662 (JSR), 2016 U.S. Dist. LEXIS 12286, at *36 (S.D.N.Y. Feb. 2, 2016) ("Although the *Cammer* factors were not designed for debt securities . . . [t]he Court agrees that the modified *Cammer* factors provide a useful rubric to evaluate debt markets."); *In re* NII Holdings, Inc. Sec. Litig., 1:14-CV-227(LMB/JFA), 2015 U.S. Dist. LEXIS 156034, at *18 (E.D. Va. Nov. 17, 2015) ("Although the showings to establish market efficiency for bond markets differs from the showing for stock exchanges, courts tend to employ the *Cammer* factors as an analytical tool when determining whether bonds traded in an efficient market.").

[232] *See, e.g.,* Stephen J. Lubben, *When Debt Markets Don't Really Act as Markets*, N.Y.

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tors. Major companies with stock trading on large U.S. exchanges register their shares in accordance with the Securities Act of 1933, making such shares freely tradable and providing easy liquidity for investors.[233] Corporate debt, however, is often sold privately through various exemptions from registration under the Securities Act of 1933.[234] Some of these securities may be restricted and, unlike their equity counterparts, may not be freely tradable and some may not fall under the purview of the Securities Act at all.[235] Furthermore, many debt instruments trade over-the-counter (OTC).[236] In OTC markets, an investor must often "search for a buyer, incurring opportunity or other costs until one is found."[237] The process of obtaining a "bid and ask"[238] is often a strategic bargaining process.[239] The end result is less liquidity and information and bargaining asymmetries.[240] "Fundamentally, corporate bond funds often hold large positions in bonds that don't trade in

TIMES (Oct. 1, 2014, 3:57 PM), http://dealbook.nytimes.com/2014/10/01/when-debt-markets-don't-really-act-as-markets/?_php=true&_type=blogs&_r=0; Downing et al., *supra* note 214, at 1083 (noting that contrary to results of prior empirical studies, the authors dataset "indicate[s] that the bond market is in general less informationally efficient than the equity market"). *But see* Edith S. Hotchkiss & Tavy Ronen, *The Informational Efficiency of the Corporate Bond Market: An Intraday Analysis*, 15 REV. FIN. STUD. 1325, 1327 (2002) (concluding that firm-specific information is "incorporated as quickly into bond prices as into prices of the underlying stock").

[233] *See generally* 15 U.S.C. § 77e(a) (2012) (prohibiting the sale of securities for which no registration statement is in effect).

[234] *See* LUBBEN, *supra* note 52, at 196.

[235] *See, e.g.,* 15 U.S.C. § 77c(a)(3) (exempting certain notes from Section 5 registration requirements); § 77c(a)(9) (exempting debt instruments issued under certain exchange offers and out of court plans of restructuring); § 77c(a)(10) (exempting certificates issued by a DIP in a chapter 11 case). *See also* 17 CFR 230.144A (2016) (commonly known as a "Rule 144A Offering;" this "safe-harbor" enables issuers to sell corporate debt to "Qualified Institutional Buyers" while avoiding the registration requirements of Section 5); STANDARD & POOR'S, A GUIDE TO THE LOAN MARKET 9 (2011), https://www.lcdcomps.com/d/pdf/LoanMarketguide.pdf ("Because loans are not securities, this will be a confidential offering made only to qualified banks and accredited investors.").

[236] *See* Newby v. Enron Corp., 529 F. Supp. 2d 644, 748 (S.D. Tex. 2006) ("Bonds are usually traded in the over-the-counter market.").

[237] Darrell Duffie et al., *Over-The-Counter Markets*, 73 ECONOMETRICA 1815, 1815 (2005).

[238] In finance, the "bid-ask spread" is defined as the difference between the price at which the buyer is willing to buy and at which the seller is willing to sell. Low bid-ask spreads are common on centralized exchanges because there are many market participants. A low bid-ask may be indicative of an efficient market as wider spreads may indicated information asymmetries, transaction costs, or unequal bargaining positions. *See* LUBBEN, *supra* note 52, at 196.

[239] Duffie et al., *supra* note 237.

[240] *See, e.g.*, Lubben, *supra* note 232; s*ee also* Downing et al., *supra* note 214, at 1083 ("[T]he transaction costs for corporate bonds remain relatively high compared to equities.").

large amounts each day."[241] This relatively low trade volume (when compared to the stock market) appears to suggest that debt markets in general are less liquid than their equity counterparts. While courts have noted that over-the-counter trading is not dispositive, the trading still may lend itself towards a finding of inefficiency.[242]

In response to these arguments, proponents of the efficient market theory's applicability to credit markets have noted that the *Cammer* factors such as liquidity, trade volume, and the presence of market makers must be analyzed differently with respect to bonds.[243] For example, when a firm's financial health is strong and improving by the day, a high trade volume should not be expected as the probability of repayment is strong even before the positive news.[244] In fact, a spike in trade volume in response to this immaterial information may be indicative of *inefficiency.*[245] Distressed debt, on the other hand, may be more sensitive to the type of information that may influence equity price.[246]

Moreover, as stated above, some commentators have noted that over-the-counter trading on its own should not be enough to establish the inefficiency of a debt instrument.[247] One court has also held that "whether market makers in the over-the-counter-market, specifically the market for [the particular security], provided a sufficiently fluid and informed trading environment so that when material information about [the issuer] was disseminated, investors had available to them an opportunity to trade at informed, and therefore appropriate, bid and asked prices."[248] Moreover, some have argued that despite the fact that these instruments trade over-the-counter with a low frequency, the major financial institutions that hold significant bond positions are sophisticated parties and are better able to distill all material publically available information and incorporate this information into the price and yield. "[Plaintiff's expert] argued that . . . [bond markets are]

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[241] Lubben, *supra* note 232.

[242] Cammer v. Bloom, 711 F. Supp. 1264, 1281 (D.N.J. 1989).

[243] *See* Michael L. Hartzmark et al., *Fraud on the Market: Analysis of the Efficiency of the Corporate Bond Market*, 2011 COLUM. BUS. L. REV. 654 (2001).

[244] *See id.* at 689.

[245] *Id.* ("[I]f information or opinions do not change each day, yet there is high frequency of trading, this might be a sign that that security actually trades in an inefficient market that possibly resembles a casino.").

[246] *See, e.g.*, Downing et al., *supra* note 214, at 1094 ("The results for hourly returns in Panel B provide support for the notion that lower-rated bonds are more equity-like and hence sensitive to firm-specific news.").

[247] Hartzmark et al., *supra* note 243, at 694–95.

[248] *In re* HealthSouth Corp. Secs. Litig., 261 F.R.D. 616, 639 (N.D. Ala. 2009) (quoting Cammer v. Bloom, 711 F. Supp. 1264, 1283 (D.N.J. 1989)).

substantially composed of large QIBs, with trained staffs and substantial research capabilities that keep them well informed, ensure[ing] the market is informationally efficient."[249] This is also evident in the market for leveraged loans, commonly used as proxies in chapter 11 cramdowns, where lenders have ready access to a plethora of material non-public information.[250] Commentators have noted that the "monitoring role" of banks in this context may support a finding that loan markets are efficient.[251]

The claim that secondary credit markets are efficient, however, may break down in the context of small-cap firms. This distinction is highly relevant because although large chapter 11 cases tend to receive the most publicity, they are nonetheless relatively rare.[252] The research of Professors Eugene Fama and Kenneth French has shown that the Capital Asset Pricing Model, closely linked with the assumptions of the ECMH, fails to adequately predict returns for smaller firms.[253] In appraisal proceedings in Delaware, courts have accepted the use of the

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[249]   Newby v. Enron Corp., 529 F. Supp. 2d 644, 767 (S.D. Tex. 2006).

[250]   *See* STANDARD & POOR'S, *supra* note 235; *see generally* Edward I. Altman et al., *Bank Debt Versus Bond Debt: Evidence from Secondary Market Prices*, J. MONEY CREDIT & BANK., June 2010, at 755.

[251]   *A Deep Dive into* Till v. SCS Credit Corp.—*Part IX: The Loan Market Appears to Satisfy Any Reasonable Standard for an Efficient Market*, THE NECESSARY AND PROPER BLOG (Jan. 3, 2014, 4:11 PM), http://thenecessaryandproperblog.
blogspot.com/2014/01/a-deep-dive-into-till-v-scs-credit-corp_6300.html (noting that the Altman study "supports the thesis that the 'monitoring' role of the loan agreement's covenants gives its holders better or at least more timely information and further that such information has value in terms of achieving a greater recovery for its recipients").

[252]   For example, the UCLA-LoPucki Bankruptcy Research Database notes that out of 1039 cases sampled, only sixty-one companies had a total asset value of ten billion dollars and over. Three hundred and ninety-two companies fell in the one to ten billion dollar range. Nearly one-third of the cases sampled fell between $500 million and $1 billion, while a slightly larger number contained assets less than $500 million. *UCLA-LoPucki Bankruptcy Research Database*, UCLA SCHOOL OF LAW (Feb. 20, 2016, 12:08 PM), http://lopucki.law.ucla.edu/design_a_study.asp. Mid-cap stocks are generally defined as companies whose market value of equity exceeds two billion dollars. Rick Wayman, *Understanding Small- and Big-Cap Stocks*, INVESTOPEDIA, http://www.investopedia.com/articles/analyst/010502.asp (last visited May 7, 2016). Because the assets of an insolvent company tend to greatly outweigh equity, a substantial portion of the surveyed cases that fall in the one to ten billion dollar range are likely to be considered "small-cap" companies. It should be noted that courts making determinations of a debt security's efficiency tend to focus on the market value of a company's debt instead. Nonetheless, the general proposition that companies with a book value of assets between one to ten billion dollars may be considered small-cap under certain circumstances may still be applicable.

[253]   Eugene Fama & Kenneth French, *Dissecting Anomalies*, 63 J. FIN. 1653 (2008); *but see* Cunningham, *supra* note 196, at 569 ("[I]n evaluating the ECMH, the need for a pricing model creates the joint-hypothesis problem: one can never be certain in testing

relevant "Ibbotson Premium" in order to reconcile this difference.[254] This makes sense as many of the prerequisites for an efficient market are no longer present in the realm of small and microcap companies.[255] These companies tend to exhibit fewer trades, less liquidity, less transparency, less analyst coverage, and more susceptibility to market manipulation than their large-cap counterparts.[256] In light of this, one prominent corporate finance professor has noted that "the small firm could be an important exception to the efficient market theory, an exception that gave investors the opportunity for consistently superior returns over a period of two decades."[257] Indeed, courts have taken market cap into consideration in securities regulation cases; a larger market cap bodes in favor of a finding of efficiency.[258]

A second relevant market in a chapter 11 cramdown is the market for distressed debt.[259] The markets for such instruments may be less likely to exhibit efficiency as the assumptions behind the ECMH break down even further in this context. First, distressed debt investing tends to be limited to a small group of investment professionals, most of

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a model whether rejections of it are required because of market inefficiency or because of an inadequately specified asset pricing model.").

[254] Cede & Co. v. JRC Acquisition Corp., No. 18648-NC, 2004 Del. Ch. LEXIS 12, at *31–32 (Del Ch. Feb. 10, 2004) ("Under CAPM the cost of equity is equal to the risk-free rate (the yield on 20 year Treasury bonds) plus a large company equity risk premium multiplied by the specific company adjusted beta for JR Cigar. Added to this figure is an equity size premium. An equity size premium is added because smaller companies have higher returns on average than larger ones . . . [and] small companies have a higher cost of equity."). Plugging a company's beta into the CAPM tends to produce a greater discrepancy with actual returns as the company's market cap decreases.

[255] *See generally Microcap Stocks: A Guide for Investors*, SEC, https://www.sec.gov/investor/pubs/microcapstock.htm (last modified Sept. 18, 2013).

[256] *See id.* ("Many microcap companies do not file financial reports with the SEC, so it's hard for investors to get the facts about the company's management, products, services, and finances.").

[257] BREALEY ET AL., *supra* note 55, at 364.

[258] *See, e.g., In re* Petrobras Sec. Litig., 312 F.R.D. 354, 367 (S.D.N.Y. 2016) ("Put simply, Petrobras was one of the largest and most-analyzed firms in the world throughout the Class Period, and such size and sophistication raise the likelihood of an efficient market."); Paul A. Ferrillo et al., *The "Less Than" Efficient Capital Markets Hypothesis: Requiring More Proof from Plaintiffs in Fraud-on-the-Market Cases*, 78 ST. JOHN'S L. REV. 81, 101 (2004) ("[M]arket capitalization . . . may be an indicator of market efficiency because there is a greater incentive for stock purchasers to invest in more highly capitalized corporations.") (quoting Krogman v. Sterritt, 202 F.R.D. 467, 478 (N.D. Tex. 2001)). Moreover, the Hotchkiss study referenced *supra* note 232 analyzed a dataset containing firms with a median book value of assets of $1820.2 million.

[259] This definition includes both leveraged loans and distressed bonds/notes as secured bond issuances are becoming a more common method for distressed firms to raise capital.

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whom attempt to "make money on mispriced assets."[260] This under-
mines the first assumption of the ECMH: a large number of market
participants. A robust market with a large number of participants may
more accurately reflect an informed consensus on the underlying
firm's true value or credit risk, and the potential for pricing inefficien-
cies is greater when few informed participants are present. In fact, one
study on this issue concluded that junk bonds display relatively less ef-
ficiency than do investment grade bonds and tend to be issued in
smaller denominations.[261] As suggested by this study, distressed debt
investors may be able to identify credit investments with artificially low
prices and high yields. Closely related to this factor is the ability of one
market participant to manipulate the market as a whole. This very na-
ture of distressed debt investing makes this a plausible reality. The
emergence of credit default swaps (CDSs) has also altered many mar-
ket participants' incentives as investors may stand to gain by putting
downward pressure on a company's bond price and forcing a company
into bankruptcy. While betting against a security occurs in all markets,
when one individual actor holds a sizable stake in a distressed firm, his
or her ability to affect the market price seems inconsistent with the
notion of an efficient market.

With respect to the primary market for syndicated loans to entities
similar to a chapter 11 debtor, the applicability of the ECMH is also
questionable.[262] This is significant: in the line of cases employing the
two-part efficiency analysis, courts focus on the market for loans to bor-
rowers similar to the debtor.[263] In *Momentive*, for example, the court
specifically rejected the use of proposed exit facility rates as proxies.[264]
By definition, however, a primary market for debt does not involve any

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[260]   Lubben, *supra* note 232. *See also* Downing et al., *supra* note 214, at 1101 (finding
that "stock returns predict returns on BBB- and junk-rated nonconvertible bonds at
both and hourly frequencies"). Such a conclusion is akin to a finding that the market
for distressed bonds may be inefficient.

[261]   *See* Downing et al., *supra* note 214, at 1086 ("Lower credit quality issuers tend to
be smaller firms—the average market capitalization of AAA issuers is about 70 times
larger than that of junk issuers.").

[262]   *See* Newby v. Enron Corp., 529 F. Supp. 2d 644, 769 (S.D. Tex. 2006) ("There is
a line of cases conclusorily holding that primary bond markets per se are not open and
have not developed at all, and thus the theory should not apply."). *But see* AAL High
Yield Bond Fund v. Ruttenberg, 229 F.R.D. 676, 684–85, 685 n.9 (N.D. Ala. 2005).

[263]   *See, e.g., In re* 20 Bayard Views, LLC, 445 B.R. 83, 109 (Bankr. E.D.N.Y. 2011)
("[C]onsideration should be given to the 'current market rates' for loans that are 'sim-
ilar in term, quality of security, and risk of repayment or financial condition of the
borrower.'") (quoting *In re* One Times Square Assocs. Ltd. P'ship, 159 B.R. 695, 706
(Bankr. S.D.N.Y. 1993)).

[264]   *In re* MPM Silicones, LLC, No. 14-22503-rdd, 2014 Bankr. LEXIS 3926, at *85
(Bankr. S.D.N.Y. Sept. 9, 2014).

sort of trading mechanism by which yield rates can react to new information based on a large informed consensus of the marketplace.[265] Creditors of distressed companies and firms in chapter 11 often wield considerable influence in setting the loan's terms and may base their pricing models on factors unrelated to the loan itself.[266] The *Momentive* court noted that "[t]his should not be surprising because it is highly unlikely that there will ever be an efficient market that does not include a profit element, fees and costs."[267]

While it is certainly true that a secured creditor is entitled to a positive return on its investment, the *economic profit* of the lender should nonetheless be zero.[268] One commentator has recently noted that "[t]he key nuance is presumably market efficiency. The expected economic profit for a loan issued in an efficient market is (near) zero because the interest will just cover the opportunity cost of capital. The expected economic profit in an inefficient market, on the other hand, can be greater than zero."[269] Moreover, distressed business lenders may implement market control by demanding a substantial premium over investment-grade loans, imposing numerous restrictive covenants in the credit agreement, wielding considerable control over the debtor's business, bargaining for options to convert the debt into common stock, imposing numerous fees and other forms of consideration, and aggressively pursuing default remedies such as the "loan to own strategy" commonly exerted by secured lenders in chapter 11.[270] Additionally, the small number of market participants may ensure that the proposed rate exceeds the true risk of non-payment. If this were the case, the present value of the future cash flows would exceed the amount of the secured lender's claim. While some commentators have put forth

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[265]   *See, e.g.*, Bromberg & Lowenfels Treatise, *supra* note 189, § 7.484(3) ("[N]ew issue markets can rarely be efficient when they begin. They are one way [selling] rather than two way [buying and selling] markets. A single price is commonly fixed by the underwriters and issuers, although usually with reference to the prevailing market for similar securities.").

[266]   *See, e.g.*, STANDARD & POOR'S, *supra* note 235, at 15 (noting that "banks are driven by the overall profitability of the issuer relationship, including noncredit revenue sources").

[267]   *In re MPM Silicones, LLC*, 2014 Bankr. LEXIS 3926, at *86.

[268]   Vitti, *supra* note 209, at 108–09 (discussing the distinction between accounting profits and economic profits and how it pertains to the cramdown analysis).

[269]   *Id.* at 109.

[270]   *See generally* Log on Am. v. Promethean Asset Management, 223 F. Supp. 2d 435 (S.D.N.Y. 2001) (distressed debtor-plaintiff entered into a "death spiral" convertible credit agreement on highly unfavorable terms due to its inability procure financing from any other market sources).

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compelling arguments that pricing loans based on market comparables may ensure that the primary market is efficient,[271] the considerations discussed above should, at the bare minimum, call into question whether these exit facilities for companies emerging from chapter 11 are as efficient as the broader market for syndicated loans.[272]

More fundamentally, many critics argue that the ECMH tends to overlook the true nature of human behavior by assuming that all investors make decisions in a rational manner.[273] These critics of the model point to various financial bubbles as evidence that individuals often overreact to material information.[274] Such thinking can carry over to the chapter 11 context, where investors' fears of the potential instability of both pre- and post-confirmation debtors may lead to abnormally high interest rates and erratic price movements. For example, when Momentive's replacement notes began trading, the yields immediately rose to 6.2%.[275] Whether this rate was a function of the debtor's true credit risk or a product of the market's overreaction to the bench ruling is unclear. While the ECMH has been lauded as one of the greatest achievements of modern financial theory, these psychological concerns have led one prominent corporate finance expert to note that

[271] *See, e.g., A Deep Dive into* Till v. SCS Credit Corp.—*Part IX: The Loan Market Appears to Satisfy Any Reasonable Standard for an Efficient Market, supra* note 251 ("The best evidence that the current US market for senior secured loans is efficient lies in the fact that, when a bank is arranging a large secured loan of any size for a commercial client, the arranger refers to comps in the loan market to estimate the pricing on the loan."); *see also* STANDARD & POOR'S, *supra* note 235, at 16 (noting that the use of mark-to-market data has "made the [loan] market more transparent, improved price discovery and, in doing so, made the market far more efficient and dynamic than it was in the past. In the primary market, for instance, leveraged loan spreads are now determined not only by rating and leverage profile, but also by trading levels of an issuer's previous loans and, often, bonds").

[272] *See generally* EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY (3d ed. 2006) ("The structure of Chapter 11 . . . may discourage an active market for control of the assets of the bankrupt firm. Oversight from the capital markets is reduced because management has access to debtor-in-possession financing. The securities of bankrupt firms trade infrequently . . . [p]erhaps as a result, there is often limited analyst coverage. The absence of market forces makes valuation more complex and sometimes less precise."); STANDARD & POOR'S, *supra* note 235, at 15 (noting that with respect to non-institutional investors, "it is an anachronism to continue to call [the primary market for loans] a 'bank' loan market").

[273] *See, e.g.,* BREALEY ET AL., *supra* note 55, at 884–85 ("Some researchers believe that the efficient-market hypothesis ignores important aspects of human behavior. For example, psychologists find that people tend to place too much emphasis on recent events when they are predicting the future.").

[274] *Id.* at 885 (citing CHARLES P. KINDLEBERGER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (4th ed. 2000); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2d ed. 2000)).

[275] Vitti, *supra* note 209, at 107.

"[m]uch more research is needed before we have a full understanding of why asset prices sometimes get so out of line with what appears to be their discounted future payoffs."[276]   These qualitative criticisms should make one pause for a moment and consider whether bankruptcy judges should accept the theory within the context of a market that has not experienced the same degree of empirical validation as the more commonly studied equity markets.

3. Efficient Credit Markets and *Till* Footnote 14

The considerations discussed above call into question whether the markets for loans to a company similar to a chapter 11 debtor can be truly efficient. At the bare minimum, these considerations indicate that since *Till*, bankruptcy courts should re-examine the way they view the concept of market efficiency in light of the policy concerns outlined by the Supreme Court. As the court in *Momentive* articulated, the "guiding principle" of *Till* is that the purpose of the discount rate is to ensure that the present value of the secured lender's future cash flows equals its allowed secured claim. Accordingly, the relevant inputs in the calculation are all factors contributing to the debtor's default risk. The ECMH is entirely consistent with this notion. As a result, the proper inquiry should be similar to the one conducted by courts applying the Modified *Cammer* factors in the context of debt securities fraud cases. Only by doing so can a court determine if market comparables paint an accurate picture of the debtor's credit risk.

Even if courts were to conduct a proper efficient markets analysis, however, the considerations discussed in Part V.B.2 indicate that such an inquiry may rarely support a finding of efficiency. And as discussed in Part IV, courts using the current standard more often than not conclude that there is no efficient market and ultimately apply the formula approach. This creates a significant problem both in terms of judicial resources drained and the financial burdens on a distressed debtor. An ECMH-based analysis would likely result in a lower "success rate" for the creditor and would be more costly for the parties, as the debtor would have to hire an expert witness to analyze the Modified *Cammer* factors. "Unfortunately, this determination can only be made after both sides have exhausted considerable expenses to prove the presence of an efficient market, which may ultimately be ineffectual if the court determines that the market is not controlling and falls back to *Till*'s formula approach."[277] Such a result hardly seems desirable.

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[276]   BREALEY ET AL., *supra* note 55, at 885.
[277]   Pill, *supra* note 4, at 295.

Another consideration is that efficiency is not an "all or nothing" concept. Courts have recognized that there are varying degrees to which a debt security can be considered informationally efficient.[278] In light of this, courts have permitted plaintiffs in securities fraud cases involving debt instruments to prevail on the efficiency analysis even when they did not demonstrate that the security was perfectly efficient.[279] Nonetheless, a crucial policy distinction is relevant in the 10b-5 context: the importance of providing defrauded investors with an adequate remedy at law without requiring an overly-stringent pleading threshold.[280] Because this concern is not relevant in the chapter 11 context, it makes sense that a higher bar for efficiency should be implemented, since the whole point of the cramdown rate analysis is to ensure the accuracy of the market rate. Such a consideration increases the probability that a court will find the market proxies as inefficient. The policy concern in the cramdown context is accuracy and not providing plaintiffs with an easier way to satisfy a prima facie element.

In light of the above, the analysis conducted by courts following *Till* footnote 14 seems inconsistent with the policies laid out in the *Till* opinion, the Supreme Court's definition of market efficiency, and the Efficient Capital Markets Hypothesis. Loans of a given duration and risk comparable to those extended to borrowers exiting chapter 11 may not necessarily yield the most accurate "risk that [a default] will occur."[281] Rather, they reflect unequal bargaining positions, transaction costs, information asymmetries, and other factors that violate the ECMH. As a result, these interest rates may not be the most accurate gauge of the debtor's post-confirmation credit risk.

The above notwithstanding, it is important to note that the foregoing analysis is not meant to definitively suggest that credit markets do not exhibit informational efficiency. Rather, the purpose of the

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[278] *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2414 (2014) ("[M]arket efficiency is not a yes-or-no proposition."); Newby v. Enron Corp., 529 F. Supp. 2d 644, 750 (S.D. Tex. 2006) ("Efficiency is a relative concept, a matter of degree. As noted, the plaintiff need not satisfy all the *Cammer/Unger/Bell* factors to establish an efficient market even for stocks, and there is no absolute or established level of evidence to demonstrate any of the factors, such as average weekly trading volume, the number of analysts following the security, active market makers.").

[279] *Newby*, 529 F. Supp. 2d. at 750.

[280] *See id.* at 749 ("Given the policy behind the federal securities laws of protecting securities investors from fraud, the Court finds it unreasonable that merely because bonds are not marketed in the same manner or as efficiently as stocks on national exchanges, one must conclude that the bond market is inefficient and thus defrauded bond investors should not have a right [to] use the fraud-on-the-market theory to permit them to pursue class action litigation.").

[281] Till v. SCS Credit Corp., 541 U.S. 465, 491 (2004) (Scalia, J., dissenting).

analysis is to point out some of relative inefficiencies that may exist in distressed debt markets when compared to equity markets. As noted by Justice Scalia in his *Till* dissent, eight of the Justices agreed that the purpose of the cramdown rate was to compensate the creditor for the risk of non-payment. The only area of disagreement was which method produced the most accurate result. It may very well be true that the formula approach may undercompensate creditors in certain circumstances. As argued above, however, it may be just as likely that a market-based approach will yield the same sort of inaccuracies. In sum, this section of the Comment has argued that: (1) the purpose of the cramdown rate is to ensure that the present value of the secured creditor's future cash flows is equal to 100% of the allowed secured claim; (2) the potential uncertainty with respect to the efficiency of these market rates means that the present value calculation may exceed 100%; and (3) in light of these potential flaws, courts should continue to apply a risk-adjusted cramdown rate until the efficiency of the primary and secondary markets for debt instruments is further validated.

VI. CONCLUSION

In the years after *Till*, courts across the country continued to apply different approaches to determine a cramdown rate in chapter 11 cases. The two predominant methods that emerged are the formula approach and the two-step coerced loan approach. Courts applying the latter have tended to rely on *Till* footnote 14 as the guidepost for their analysis. The public policy concerns outlined in the main body of the *Till* opinion, however, should outweigh the influence of footnote 14. Cramdown rates exist to put a secured lender in the same position as one who receives a lump sum paying in satisfaction of his claim, not to help him capture additional profits. Moreover, as noted by Justice Thomas in his *Till* dissent, there is no fundamental difference between the rate determination process in chapter 11 and chapter 13. Furthermore, adjusting the discount rate upward alleviates many financial burdens on the debtor and best comports with the bankruptcy court's task of evaluating the feasibility of a debtor-in-possession's plan for reorganization. Such an approach will maximize a corporate debtor's chances of successfully emerging from bankruptcy.

When viewed in conjunction with public policy considerations, the Supreme Court's endorsement of the Efficient Capital Markets Hypothesis in *Basic Inc.* indicates that the ECMH may be the fundamental underpinning of footnote 14. Whether this was the Justices' intended meaning or not, such a definition makes sense in light of the overall

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purpose of the cramdown interest rate. The small size of a typical chapter 11 debtor, imperfect bargaining positions of a lender and a distressed borrower, and a small number of market participants all suggest that the market for credit to companies in chapter 11 may never truly be "efficient" as defined by the Supreme Court in *Basic Inc.* The fact that a market for loans to similar debtors exists does not justify its use as cramdown proxy, particularly in light of the fact that a plurality of the Supreme Court patently rejected the contention that lenders should be allowed to reap the same profit they could have obtained by investing in leveraged loans to entities similar to the debtor. It follows that the two-step approach endorsed by *American HomePatient* will rarely yield a result consistent with the ECMH and the Supreme Court's reasoning.

For the reasons discussed above, the formula approach as articulated in *Till* and *Momentive* should be the standard method for determining cramdown rates in chapter 11. Such an approach is most consistent with *Till*'s fundamental principal, footnote 14, the policy behind the Bankruptcy Code, and modern financial theory.