HUNTON& WILLIAMS

Client Alert

March 2013

Fifth Circuit Establishes Appropriate *Till* Analysis in Chapter 11 Proceedings

On March 1, 2013, the Fifth Circuit Court of Appeals issued an opinion in *Wells Fargo Bank N.A. v. Texas Grand Prairie Hotel Realty, L.L.C. et al, (In re Texas Grand Prairie Hotel Realty, L.L.C.)*[1] ("*Texas Grand Prairie*") affirming an order of the bankruptcy court confirming a debtor's plan of reorganization over the objection the secured creditor that argued that the interest rate proposed by the plan to be paid to the secured creditor was too low in violation of 11 U.S.C. §1129(b). In *Texas Grand Prairie*, the Fifth Circuit refused to endorse any particular formula for determining an appropriate cramdown interest rate in a Chapter 11. However, the court clarified the appropriate analysis bankruptcy courts should undertake when using the "prime-plus" methodology set forth in *Till v. SCS Credit Corp.*[2] in the context of a chapter 11 plan of reorganization and specifically rejected an attempt by the Lender to boot-strap a forced loan analysis into *Till*.

<u>Case Background</u>

In 2007, Texas Grand Prairie Hotel Realty, LLC, Texas Austin Hotel Realty, LLC, Texas Houston Hotel Realty, LLC, and Texas San Antonio Hotel Realty, LLC (collectively, "Debtors") obtained a $49,000,000 loan (the "Loan") from Morgan Stanley Mortgage Capital, Inc., to acquire and renovate four hotel properties in Texas. To secure repayment, Morgan Stanley — not a party to this case — took a security interest in the hotel properties and in substantially all of the Debtors' other assets. Subsequently, Wells Fargo Bank N.A. ("Wells Fargo") was named trustee for the trust (the "Lender") that eventually acquired the Loan.

Unable to repay the Loan at maturity, the Debtors filed for Chapter 11 protection and proposed a plan of reorganization. When the Lender voted against the plan, the Debtors sought to confirm the plan over the Lenders objection pursuant to 11 U.S.C. § 1129(b). The plan valued the Lender's secured claim at roughly $39,080,000 based on the Lender's appraisal. Under the plan, the Debtors proposed to pay off the Lender's secured claim over ten years utilizing a twenty year amortization with interest at 5%. The Lender objected to the proposed treatment on the basis that the interest rate was too low.

<u>Bankruptcy Court Decision</u>

At the confirmation hearing, the Lender object to, among other things, the 5% interest rate proposed to be paid on its secured claim. Both parties stipulated that the applicable interest rate should be determined by applying the "prime-plus" formula endorsed by a plurality of the Supreme Court in *Till v. SCS Credit*

[1] *Wells Fargo Bank N.A. v. Texas Grand Prairie Hotel Realty, L.L.C. et al, (In re Texas Grand Prairie Hotel Realty, L.L.C.)*, No. 11-11109, 2013 WL 776317 (5th Cir. Mar. 1, 2013).

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

Corp.[3] However, the parties' experts disagreed on the application of that formula: the Debtors' expert testified that *Till* supported a 5% rate, while the Lender's expert insisted that *Till* mandated a rate of at least 8.8%.

In arriving at his recommended 5% rate, the Debtor's expert began his analysis by quoting the prime rate at 3.25%. He then proceeded to assess a risk adjustment by evaluating the factors enumerated by the *Till* plurality: looking to "the circumstances of the [D]ebtors' estate, the nature of the security, and the duration and feasibility of the plan." The Debtor's expert concluded that the Debtors' hotel properties were well maintained and excellently managed, that the Debtors' owners were committed to the business, that the Debtors' revenues exceeded their projections in the months prior to the hearing, that the Lender's collateral was stable or appreciating, and that the Debtors' proposed plan would be tight but feasible. On the basis of these findings, the Debtor's expert assessed the risk of default "just to the left of the middle of the risk scale." As *Till* had suggested that risk adjustments generally fall between 1% and 3%, the Debtor's expert reasoned that a 1.75% risk adjustment would be appropriate.

The Lender's expert, corroborated virtually all of the Debtor's expert findings with respect to Debtors' properties, management, ownership, and projected earnings. The Lender's expert also agreed that the applicable prime rate was 3.25%. However, the Lender's expert devoted the vast majority of his analysis to determining the rate of interest that the market would charge to finance an amount of principal equal to the cramdown loan. Because the Lender's expert concluded that there was no market for single, secured loans comparable to the "forced loan" contemplated under the plan, he calculated the market rate by taking the weighted average of the interest rates the market would charge for a multi-tiered exit financing package comprised of senior debt, mezzanine debt, and equity resulting in a "blended" market rate of 9.3%. To bring his "market influenced" analysis within the form of *Till*'s prime-plus method, the Debtor's expert purported to "utilize the [3.25%] Prime Rate as the Base Rate," making an upward "adjustment" of 6.05% to account for "the nature of the security interest." This calculation equaled the 9.3% blended market rate. The Debtor's expert then adjusted the blended rate in accordance with the remaining *Till* factors, making a downward adjustment of 1.5% to account for the sterling "circumstances of the bankruptcy estate" and an upward adjustment of 1% to account for the plan's tight feasibility. Ultimately, the Lender's expert concluded that the Lender was entitled to an interest rate of 8.8%.

At the conclusion of the testimony of the Debtor's expert, the Lender filed a *Daubert*[4] motion seeking to strike his testimony under Rule 702, insisting that his . . . failure to correctly apply *Till* and its progeny show[s] that his methodology is flawed, does not comport with applicable law, and is unreliable." The bankruptcy court denied the challenge and adopted the Debtor's expert testimony, finding that "the Debtor's expert properly interpreted *Till* and properly applied it," and that his "assessment of the circumstances of the estate, the nature of the security, and the feasibility of the plan . . . [were] credible and persuasive." The court went on to reject the Lender's expert testimony, finding that his expert analysis was inconsistent with *Till*'s prime-plus method. The court specifically found that the Lender's expert's method was more in the nature of a forced loan approach, which was expressly rejected by the Court in *Till*. Consequently, the court concluded that the appropriate risk adjustment was 1.75% and thus, that the Lender was entitled to a 5% interest rate. The bankruptcy court went on to confirm the Debtors' plan of reorganization.

[3] The *Till* decision arose in the context of a contested Chapter 13 plan process, but has been applied by numerous courts in the Chapter 11 context. Under the *Till* formula method, a bankruptcy court should begin its cramdown rate analysis with the national prime rate — the rate charged by banks to creditworthy commercial borrowers — and then add a supplemental "risk adjustment" to account for "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." Though the plurality "d[id] not decide the proper scale for the risk adjustment," it observed that "other courts have generally approved adjustments of 1% to 3%." *Till*, 541 U.S. at 474-476, 480.

[4] *Daubert v. Merrell Dow Pharmaceuticals, Inc*., 509 U.S. 579, 589 (1993).

The Lender appealed to the district court, challenging the bankruptcy court's decision to admit the Debtor's expert testimony as well as the court's adoption of his interest-rate analysis. The district court affirmed and the Lender appealed to the Fifth Circuit.

<u>The Fifth Circuit's Decision</u>

A. The Lender's Appeal Was Not Equitably Moot

At the outset, the Fifth Circuit addressed the Debtors' contention that the Lender's appeal should be dismissed as equitably moot. The doctrine of equitable mootness is unique to bankruptcy proceedings, responsive to the reality that "there is a point beyond which a court cannot order fundamental changes in reorganization actions."[5] To establish equitable mootness, a debtor must show that (i) the plan of reorganization has not been stayed, (ii) the plan has been "substantially consummated," and (iii) the relief requested by the appellant would "affect either the rights of parties not before the court or the success of the plan."[6]

The Lender stipulated that the first two elements were satisfied. The Lender argued that the third element had not been satisfied as the Fifth Circuit could not order partial relief which would not "affect either the rights of parties not before the court or the success of the plan."[7] The Fifth Circuit agreed, noting that the Debtors had presented no credible evidence that granting relief would require unwinding any of the transactions undertaken pursuant to the reorganization plan or that granting relief would unduly burden the rights of third parties not before the court. Accordingly, the Fifth Circuit denied the Debtors' motion to dismiss based on equitable mootness and proceeded to address the merits of the appeal.

B. The Debtors' Expert Correctly Applied the *Till* Formula

In deciding *Texas Grand Prairie*, the Fifth Circuit first reaffirmed its *T-H New Orleans*[8] decision in which it expressly stated that it did not endorse any one method of determining the appropriate rate of interest in a chapter 11 proceeding. The Fifth Circuit, specifically took great pains to establish that while the *Till* methodology was used in this case, per the stipulation of both parties, *Till* was not the sole method of determining the rate of interest in contested chapter 11 proceedings in the Fifth Circuit.[9]

Having established that there is no single approved methodology for determining the appropriate cramdown interest rate in chapter 11 proceedings, the Fifth Circuit noted that the parties stipulated that

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[5] *In re Scopac*, 624 F.3d 274, 281 (5th Cir. 2010) (*Scopac I*)

[6] *Id*.

[7] *Id*.

[8] *In re T-H New Orleans Ltd. P'ship*, 116 F.3d 790, 800 (5th Cir. 1997)

[9] In *Till*, a plurality of the U.S. Supreme Court ruled that bankruptcy courts must calculate the Chapter 13 cramdown rate by applying the prime-plus formula. The plurality noted that the prime-plus approach should also govern under chapter 11. In *Texas Grand Prairie*, the Fifth Circuit reaffirmed its previous holding that *Till* was a splintered decision involving a chapter 13 cramdown whose precedential value is limited even in the Chapter 13 context. The Fifth Circuit further stated that while many courts have chosen to apply the *Till* plurality's formula method under Chapter 11, they have done so because they were persuaded by the plurality's reasoning, not because they considered *Till* binding. The Fifth Circuit ultimately concluded that the plurality's suggestion that its analysis also governs in the Chapter 11 context is not "controlling . . . precedent." As a result, the Fifth Circuit held that it would "not tie bankruptcy courts to a specific methodology as they assess the appropriate Chapter 11 cramdown rate of interest."

the *Till* methodology applied and turned to the facts in the case before it. Since the issue on appeal related to the lower court's findings of fact, the court used the clearly erroneous standard of review.

The Fifth Circuit found that, as the plurality in *Till* instructed, the Debtor's expert engaged in a holistic evaluation of the Debtors, concluding that the quality of the bankruptcy estate was sterling, that the Debtors' revenues were exceeding projections, that the Lender's collateral — primarily real estate — was liquid and stable or appreciating in value, and that the reorganization plan would be tight but feasible. On the basis of these findings — which were all independently verified by the Lender's expert — the Debtor's expert assessed a risk adjustment of 1.75% over the prime rate of interest. The Fifth Circuit noted that this risk adjustment fell squarely within the range of adjustments other bankruptcy courts have assessed in similar circumstances. The Fifth Circuit also found that the Lender's expert predicated his 8.8% cramdown rate on the sort of forced loan analysis rejected by the *Till* plurality.

In reaching its conclusion, the Fifth Circuit addressed the Lender's contention that the plurality in *Till* repeatedly referenced "the market for comparable loans" as "relevant" and thus, the Lender's inclusion of the market for comparable loans in its analysis was proper. The Fifth Circuit rejected the Lender's argument, stating that aside from the fact that the Lender took the quoted language out of context, *Till* expressly rejected methodologies that "require[] the bankruptcy courts to consider evidence about the market for comparable loans," noting that such approaches "require an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans."[10]

The Fifth Circuit also noted that, curiously, the Lender did not try to predicate its "market influenced" blended rate calculation on the *Till* plurality's Footnote 14, which suggests that a "market rate" approach should apply in Chapter 11 cases where "efficient markets" for exit financing exist.[11] The Fifth Circuit noted that many courts — including the Sixth Circuit — have found Footnote 14 persuasive.[12] Even assuming, however, that Footnote 14 has some persuasive value, it does not suggest that the bankruptcy court here committed any error. Among the courts that adhere to Footnote 14, most have held that markets for exit financing are "efficient" only if they offer a loan with a term, size, and collateral comparable to the forced loan contemplated under the plan.[13] In the present case, the Lender's expert acknowledged that "there's no one in this market today that would loan this loan to the debtors — one to one loan-to-value ratio, 39 million dollars, secured by these properties." While the Lender's expert concluded that exit financing could be cobbled together through a combination of senior debt, mezzanine debt, and equity financing, courts, including the Sixth Circuit have rejected the argument that the existence of such tiered financing establishes "efficient markets," observing that it bears no resemblance to the single, secured loan contemplated under a cramdown plan.[14]

By reason of the foregoing, the Fifth Circuit held that bankruptcy court had not committed clear error when it confirmed the Debtors' reorganization plan which provided the Lender with a 5% discount rate. Accordingly, the Fifth Circuit affirmed the district court's affirmation of the bankruptcy court's decision.

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

[11] *Till*, 541 U.S. at 477 n.14.

[12] *See In re Am. HomePatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005)

[13] *E.g., In re 20 Bayard Views, LLC* 445 B.R. 83, 110–11 (Bankr. E.D.N.Y. 2011); *In re SW Boston Hotel Venture*, 460 B.R. 38, 55 (Bankr. D. Mass. 2011).

[14] *Am. HomePatient*, 420 F.3d at 568–69; *20 Bayard Views*, 445 B.R. at 110–11; *SW Boston Hotel*, 460 B.R. at 55–58

Conclusion

The Fifth Circuit's decision in *Texas Grand Prairie* is instructive for debtors and creditors on the way in which *Till* will be applied when determining the appropriate interest rate, when *Till* is applied at all. *Texas Grand Prairie* is further notable for the Fifth Circuit's continued determination that it leave the decision on whether to apply *Till* in chapter 11 proceedings to the discretion of the bankruptcy courts.

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