**<u>Notes from the ACREL Amicus Committee</u>**

**To: Capital Markets Committee: Bankruptcy Committee: Law Professors;**

**Re: Recent and pending appellate litigation re real estate restructuring**

**Date: June 29, 2018**

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The ACREL Amicus Committee is monitoring appellate cases that are important to members of the College and concern real estate bankruptcy cases. Some of the below cases are almost certain to become landmark decisions that will materially change the credit risk of real estate lending and the likely outcome of a real estate or retail bankruptcy under Chapter 11 of the Bankruptcy Code.[1] An increase in real estate bankruptcy cases is possible given the confluence of increases in interest rates, voluminous store closings in the retail business, and pressures on rental rates in commercial offices.

The bankruptcy restructuring process for real estate involves three critical stages and issues; (1) is there legal authority to file a bankruptcy? (2) does the debtor have the required votes to obtain plan confirmation? and (3) does the plan independently meet the legal standards for confirmation, including cram-down where the votes of a class have not been obtained? Each of these three critical issues have been the topic of recent case law and appellate activity; each shows a demonstrable trend. The courts are growing increasingly liberal on voting and substantive requirements for plan confirmation. To counter this, the lending industry continues to erect barriers that trade under the rubric of remoteness, such as the use of "golden shares." [2]

The cases discussed in this report address issues which arise during all three of these critical phases of the bankruptcy process—from issues of eligibility to file to considerations of how to determine the applicable cram-down interest rate. We also discuss the potential risk that an operating debtor may be substantively consolidated with its owners; whether mezzanine lenders can be crammed down, the key restructuring issue of the applicable interest rate on cram down loans, as well as calculating what is the "allowed amount" of a claim, including make-whole obligations; and the debtor's ability to assign claims to friendly "non-insiders" in order to obtain

[1] This update is for the use of the College and its Members and is not intended to be legal advice.

[2] It is your author's view that the rationale for bankruptcy remoteness is misguided. Congress has calibrated the conflicting needs of debtors and borrowers to insure a valuable *pro rata* and collective distribution scheme. There is no basis to permit escaping this scheme in order to benefit one group of creditors over another; there is no basis to conclude that bankruptcy itself cause economic harm or that it is a worse outcome than state-law outcomes. And finally, there is no true justification to conclude that pro-debtor provisions tilt the balance instead of reflect the correct balance of competing interests.

the required votes for plan confirmation. In addition, we discuss a key issue in retail bankruptcy cases dealing with the protection of trademark licensees.

While some of these cases are concluded, others are still on-going. Given the importance of some of these cases, members of the College, or their clients, may wish to participate in the appellate process by the filing of an amicus curiae brief. The Amicus Committee is able to assist College members or their clients in filing amicus briefs. Amicus briefs can also be filed by an institution, a group of law professors, or even a single individual. Recent scholarly studies demonstrate that the Supreme Court frequently relies on amicus briefs filed on bankruptcy issues. *See,* Ronald J. Mann, *Bankruptcy and the U.S. Supreme Court* (2018) (Chapter 13 outlines the broad use of amicus briefs in bankruptcy cases.)

Amicus committee member David Kuney has an active pro bono, amicus practice before the U.S. Supreme Court and various circuit courts. He is willing to consult with, or assist with, any member of the College on the filing of an amicus brief. He is especially interested in working with any clients who are involved in issues involving bankruptcy remoteness.

## Golden shares/bankruptcy remoteness

While the bankruptcy courts are generally making real estate restructuring more debtor-friendly, the lending community continues to utilize contractual and legal restrictions on the use of bankruptcy for real estate owners, in the hope that the filing of bankruptcy will be "remote." The "springing guaranty" has been generally enforced by the state courts.[3] Yet, at the bankruptcy court level, there is a noted uptick in decisions which question the enforceability of remoteness provisions on public policy grounds.[4] These cases involve the over-arching conflict between federal policy against contractual devices that prohibit or restrict the filing of bankruptcy and state law rights, embodied in both statute and organic documents, that permit shareholders to vote against a bankruptcy filing. This conflict remains on-going, with no definitive resolution in sight.[5]

One well-known device is the "blocking director." The bankruptcy courts' reactions to the use of a lender friendly director, *selected by a creditor,* and who serves on the board of directors for the primary purpose of voting against a bankruptcy—has been skeptical. *See e.g., In re Kingston Squa*re, 214 B.R. 713 (Bankr. S.D.N.Y. 1997) where the debtor's principals had their law firms solicit creditors to file involuntary chapter 11 petitions because they had been unable to obtain the vote of the director selected by the lender for a voluntary filing. The court denied the motion to dismiss the bankruptcy on the alleged grounds of bad faith. The court had little patience with the failure of the director to approve the bankruptcy filing who demonstrated in his live testimony an almost complete lack of knowledge concerning the affairs of the debtor. The evidence also showed that the debtor could be well-served by the bankruptcy filing.

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[3] See David Kuney, *Rethinking the Springing Guaranty,* The Practical Lawyer, Vol 32. No. 6, Nov. 2016. This article contains citation to many of the state law cases that support enforcement of the springing guaranty, but suggests that the time has come to reconsider whether they should be held to be violative of federal bankruptcy policy.

[4] *See In re Intervention Energy Holdings, LLC,* 553 B.R. 258 265 (Bankr. D. Del. 2016).

[5] *See* Adrian Nasr, *Special-Purpose Entity Lending Structures: What Developments Have Been Made Since the Landmark Decision in In re General Growth Properties, Inc.,* 25 ABI Law Review no. 2, 177 (Summer 2017).

A more modern strategy is the use of "golden shares," addressed in the recent decision of *Franchise Serv. of North Am. V. U.S. Trustee (In re Franchise Services of North America, Inc.),* 891 F.3d 198 (5th Cir. June 14, 2018). This case bears close attention by the lending community because it takes a position on the need for a controlling shareholder to exercise any fiduciary duty in deciding whether to approve a bankruptcy filing.

Franchise Services of North America ("FSNA"), a car rental company, purchased Advantage Rent-A-Car. Equity financing was provided by Macquarie Capital which made a $15 million investment through its wholly owned subsidiary (Boketo LLC). In exchange FSNA gave Boketo 100% of its preferred stock. Macquarie required that FSNA reincorporate in Delaware and adopt a new certificate of incorporation that provided that FSNA could not "effect any Liquidation Event" unless it had the approval of both the holders of the majority of the preferred stock and separately, the holders of the common stock. Any steps toward the filing of a bankruptcy petition were said to fall within the ambit of a Liquidation Event. Thus, at the outset, the "remoteness" device had been established by a bona fide equity holder, and *not* a creditor.

Macquarie, however, later became a creditor as well. FSNA agreed to pay Macquarie a $2.5 million arrangement fee and a $500 thousand financial advisory fee. Neither were paid when FSNA filed for bankruptcy, thus making Macquarie *both* the holder of a large unsecured claim and the holder of 100% of the preferred stock in Boketo. In effect, the sole preferred shareholder could veto a bankruptcy, and at the same time, was owned by a major creditor of the debtor.

FSNA filed for bankruptcy without requesting or receiving the consent of a majority of its preferred and common shareholders. Macquarie and Boketo filed a motion to dismiss the bankruptcy citing the lack of shareholder authority. FSNA countered by arguing that the shareholder consent was an invalid restriction on its right to file a bankruptcy petition.

Because Boketo was an owner rather than a creditor of FSNA, the bankruptcy court held that conditioning FSNA's right to file a voluntary petition on Boketo's consent was not contrary to federal bankruptcy policy. On FSNA's motion, the bankruptcy court sought certification from the Fifth Circuit on three questions. First, is a "blocking provision" or a "golden share" provision, which gives a party (whether a creditor or an equity holder) the ability to prevent a corporation from filing bankruptcy, contrary to federal public policy. *Id.* at 204. Second, if a party is *both* a creditor and an equity holder and holds a blocking provision, is the blocking provision or the golden share valid or contrary to federal policy. Third, under Delaware law may a certificate of incorporation contain a blocking provision or golden share provision and if so, does Delaware law impose a fiduciary duty to exercise such provision in the bests interests of the corporation. *Id*. at 204.

The Fifth Circuit declined to address the issues as presented by the debtor. ("We decline to answer the bankruptcy court's first certified question regarding the enforceability of "blocking provisions" an "golden shares" *generally*.") *Id*. at *205 (emphasis added). Instead, the Fifth Circuit limited its ruling to whether federal and Delaware law permit the parties to amend a corporate charter to allow a non-fiduciary shareholder fully controlled by an unsecured creditor to prevent a voluntary bankruptcy petition. *Id.* at *206. (It is worth noting that FSNA was a Delaware *corporation* and not the typical real-estate borrower, which is generally a limited liability company, with potentially different rules concerning waiver of an owner's fiduciary duty.)

The debtor argued that the arrangement violated federal public policy against waiving the protections of the Bankruptcy Code. It cited to a "slew of bankruptcy court" decisions where a lender extracted an amendment to the organization's foundational documents granting the lender a right to veto a bankruptcy in exchange for forbearance. *Id*. at 207. Nevertheless, it held as follows: "There is no prohibition in federal bankruptcy law against granting a preferred shareholder the right to prevent a voluntary bankruptcy filing just because the shareholder also happens to be an unsecured creditor by virtue of an unpaid consulting bill." *Id.* at 208.

The Fifth Circuit also stated that the shareholder did not have to act in accordance with any fiduciary duty when deciding on whether to permit a bankruptcy filing. The Fifth Circuit acknowledged cases that did require that directors appointed by creditors must conduct themselves in accordance with a fiduciary duty when considering whether to approve a bankruptcy filing. *See In re Lake Mich. Beach Pottawattamie Resort,* 577 B.R. at 684-66 ("The essential playbook for a successful blocking director structure is this: the director must be subject to normal director fiduciary duties.") But, not here said the Fifth Circuit. "As a matter of federal law, fiduciary duties are not required to allow a *bona fide shareholder* to exercise its right to prevent a voluntary bankruptcy petition." *Id*. at 209.

It is hard to reconcile this statement from the bankruptcy court in Delaware in *Intervention Energy Holdings:* ("[I]t is well settled principal that an advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy. . . [Operating agreements that] place into the hands of a single, minority equity holder the ultimate authority to eviscerate the right of that entity to seek federal bankruptcy relief. . . is tantamount to an absolute waiver of the right, and even if arguably permitted by state law, is void as contrary to federal public policy."

The well-known quote by Judge Gropper in *General Growth,* cited again *In re Lake Michigan Beach Pottawattamie Resort LLC,* 547 B.R. 899, 913 (Bankr. N.D. Ill. 2016) is also at odds with *Franchise Services*: "[I]f Movants believed that an 'independent' manager can serve on a board solely for the purpose of voting 'no' to a bankruptcy filing because of the desires of a secured creditor, they were mistaken." 409 B.R. at 64.

The Fifth Circuit distinguished, to some extent, the use of a golden share solely by a creditor. The Fifth Circuit said it strained credulity to suggest Macquarie made a $15 million investment "just to hedge against the possibility that FSNA might not pay a $3 million bill." *Id*. at 208. In other words, the Fifth Circuit did not see that the equity position was merely a lender's device to insure payment through a veto right in the event of bankruptcy. "We are not confronted with a case where a creditor has somehow contracted for the right to prevent a bankruptcy or where the equity interest is just a ruse." *Id*. at 208, n. 2.

What then would prevent a lender from requiring that one of the bona fide owners of an LLC agree not to file? Presumably, a lender cannot demand a contractual waiver of bankruptcy. But does this decision now mean that a "*bona fide equity*" investor can be given preferred stock and granted a veto over the filing of bankruptcy, and may exercise that right without reference to any fiduciary duty? And does it mean that the investor's parent corporation may later lend money to the debtor, now knowing that the borrower cannot file for bankruptcy? [6]

I am advised by counsel for the debtor that the case has settled, and no further appeals will be sought. Thus, this case will remain good law in the Fifth Circuit.

## **Substantive consolidation with non-debtors.**

Assuming that real estate borrowers can satisfy the state law requirements for authorizing the bankruptcy filing, a threshold issue of concern to debtors is whether the filing by an operating borrower/debtor could lead to a substantive consolidation with one of the owning entities, including a parent LLC and ultimately the individual owners. As a generality, it appears that substantive consolidation for real estate entities has been sought mostly where there was some evidence of bad faith, or disregard of entity level formalities. Generally, consolidation with non-debtors has been highly questioned. Indeed, substantive consolidation is said to be an "extraordinary remedy."

Nevertheless, in a recent case, a creditors committee attempted to invoke a substantive consolidation with over 200 related, *non-debtor* entities. It failed to do so, but mostly because the non-debtors were not-for-profit entities and were not eligible under the Code to be subjected to an involuntary filing. The case remains important because it illustrates that substantive consolidation remains a strategy for creditors and creditor committees which are seeking a source of payment from an over-leveraged borrower who can likely only pay its secured creditor.

In *The Archdiocese of Saint Paul and Minneapolis v. The Official Committee of Unsecured Creditors, (In re Archdiocese of St. Paul and Minn.),* 888 F.3d 944 (8th Cir. 2018) a creditors committee sought to compel substantive consolidation with over 200 affiliated non-profit and non-debtors (the "Targeted Entities"). In their motion, the Committee argued that the Archdiocese's assets were held by the Targeted Entities, and that the Archdiocese had direct control and supervision in all material aspects of the Targeted Entities.

The Eighth Circuit recognized that a bankruptcy court may substantively consolidate debtor entities, citing *In re Giller,* 962 F.2d 796 (8th Cir. 1992), particularly where the debtors

[6] One should note the comment made by the New York court concerning an owner's duty (of a corporate debtor) to consider filing for bankruptcy: "Had Lichtenstein failed to authorize or delayed ESI's bankruptcy filing, he would have been faced with uncapped personal liability on the basis of a breach of his duty to act in good faith. Such a breach occurs "when a director 'intentionally acts with a purpose other than that of advancing the best interests of the corporation' ..." (In re USA Detergents, Inc., 418 B.R. 533, 545 [D.Del.2009] [citation omitted] )." *Lichtenstein v. Willkie Farr & Gallagher LLP*, 120 A.D.3d 1095, 1098–99, 992 N.Y.S.2d 242, 246 (2014)

shared a common sole or majority shareholders and where there was evidence of abuse of the corporate form such as transfers among the entities that could give rise to claims of fraudulent conveyances. The leading cases supporting substantive consolidation are *Owens Corning,* 419 F.3d at 205 (3rd Cir. 2005), *In re Augie/Restivo Baking Co.,* 860 F2d 515 (2d Cir. 1988) and *In re Auto-Train Corp.* 810 F2d 270 (D.C. Cir. 1987). The Court recognized that substantive consolidation requires the creditors of one entity share its recoveries with the creditors of a potentially less solvent entity, thus unfairly disadvantaging some creditors' recovery; for this reason, "there is a broad consensus that substantive consolidation is an 'extraordinary remedy".

In the real estate context, the key question is often whether a debtor can be consolidated with a non-debtor, which may mean a mezzanine entity that has provided capital to the operating debtor, or the individual owners of the operating entity. If permitted, this could expose the assets of the owners to claims by the mortgage lender, and in particular, to claims of a large unsecured deficiency claim by a mortgage lender.

The Eighth Circuit noted that only the Ninth Circuit has directly addressed the substantive consolidation of debtors with non-debtors, citing *In re Bonham,* 229 F.3d 750, 769-71 (9th Cir. 2000) (allowing consolidation where debtor commingled personal assets with non-debtor entities and failed to maintain corporate separateness). However, the Eighth Circuit held that it could not substantively consolidate the Targeted Entities because they were properly included within the definition of an entity that is "not a moneyed, business or commercial corporation" under Code § 303(a), were not eligible for an involuntary bankruptcy filing, and hence could not be involuntarily consolidated with the debtor. Significantly, the Court held that "We leave for another day the issue of whether a non-profit non-debtor that is the alter ego, under state law, of the debtor, or has been formed as part of a fraudulent scheme can be consolidated."

Significantly, the Eighth Circuit did not state that substantive consolidation with a non-debtor is not permitted under any circumstances. The Eighth Circuit thus left open the possibility that consolidation remains a viable strategy for committees and creditors, at least where there is a showing of "alter ego" status, or other abuse. Thus, this case may be read by many as somewhat increasing the risk of substantive consolidation in all bankruptcy cases, including real estate cases. Members may wish to advise their clients that substantive consolidation with non-debtors remains at least a possibility, especially where there is strong evidence of abuse of entity separateness or fraudulent transfers among and between the entities.

The Eighth Circuit affirmed the district court on April 26, 2018. The parties had 90 days to file a petition for writ of certiorari that expires on July 25, 2018. No petition had been filed as of this date.

## **Assigning insider claims to friendly non-insiders**

While the public policy issues of structural remoteness remain unresolved, and consolidation is still an "extraordinary remedy" the bankruptcy courts have steadily drifted toward more liberal views of the Code and in that sense, have made confirming a plan of reorganization for a real-estate entity more likely and have permitted more debtor-friendly plan provisions.

A major shift has occurred in the voting requirements for plan confirmation. In order to confirm a plan of reorganization, a real estate borrower must obtain the assenting vote of at least one class of creditors, not including any insiders. 11 U.S.C. § 1129(a)(10). This requirement has proven to be nearly insurmountable in typical real estate bankruptcy cases. A real estate case is likely to have only two classes of creditors; the secured mortgage loan, which goes in one class, and all other unsecured creditors in the second class. The mortgage lender will control both its own class of secured creditors, and, if it has a large unsecured mortgage deficiency claim, will control the votes of the unsecured class. A class must vote to affirm the plan by holders of more than 50 per cent of the holders, who hold more than two-thirds of the debt. Votes of insiders do not count. Thus, a real estate borrower with a handful of small vendor creditors can rarely satisfy the voting requirements for plan confirmation. The American Bankruptcy Institute's Commission To Study the Reform of Chapter 11 recommended that § 1129(a)(10) be eliminated from the Code.[7]

Debtors have sought various strategies to avoid this outcome. One strategy has been to try to sell an insider claim to a friendly non-insider, and thus contend that the vote should count for plan confirmation. A recent decision by the U.S. Supreme Court may make it somewhat easier to obtain the required vote of a non-insider class, because it has clarified the legal standard for appellate review of what constitutes a "non-statutory insider," that is, a party who is deemed to be an insider because of his or her close relationship with the debtor. *U.S. Bank N.A. v. The Village at Lake Ridge, LLC (In re Village at Lakeridge, LLC),* 138 S.Ct. 960 (March 5, 2018).

Lakeridge was a corporate entity, which had a single owner, MBP Equity partners, and a pair of substantial debts. US Bank was owed over $10 million. MBP was owed another $2.76 million. Because MBP was the owner of the debtor, its claim was considered to be an insider claim, and thus its vote for plan confirmation would not count. In order to avoid the insider problem, Kathleen Bartlett, a member of the Board, offered to sell the MBP claim of $2.76 million to her long-standing boy-friend, Robert Rabkin, a retired surgeon, for $5,000. Although it was undisputed that they had a romantic relationship, the court found that he was not a "non-statutory" insider. Among other things, Rabkin did "adequate due diligence" and claimed he purchased the claim as a "speculative investment." Rabkin and Bartlett lived in separate homes, and managed their finances independently. They were dating but did not "cohabitate." The bankruptcy court found that the transaction was "conducted at arms-length" despite the romantic relationship.

Significantly, the Supreme Court did not grant certiorari on the related question of whether Rabkin had automatically inherited MBP's statutory insider status by merely purchasing the claim. Further, the Court declined to review the test used in the Ninth Circuit to determine if Rabkin was a non-statutory insider. This test required a two-part analysis: whether the person's relationship with the debtor was similar to those of a listed statutory insider and whether the transaction was

[7] "The confirmation of a chapter 11 plan should not require the acceptance of the plan by at least one class of claims impaired under the plan. Accordingly, section 1129(a)(10) should be deleted." ABI Commission to Study the Reform of Chapter 11, (2014) p. 257.

"less than arm's length." The Court said, "We simply take that test as a given in deciding on the standard of review."

The Court held that once the legal standard was established, the question then becomes whether the rule of law as applied to the established facts was violated. This is a "mixed question" of law and fact. The standard for review by appellate courts in reviewing a decision by a bankruptcy court could either be *de novo* (and hence a fresh determination") or a "clear error" standard, that requires the reviewing court to give "deference" to the fact finder. Not all mixed questions are alike said the Court. But where the mixed question involves case-specific factual issues, and that compel the court to marshal and weigh evidence, the appellate court should review the decision on a "clear error" standard with a "thumb on the scale" in favor of the trial court.

At bottom, what the Court found was that an appellate court may not independently review a garden-variety factual determination by a bankruptcy court and whether the facts demonstrate an arms-length transaction and do or do not confer insider status. This final statement, submerged in a footnote is what makes this case important to real estate lenders and owners. The Supreme Court was essentially telling the appellate courts to give the bankruptcy courts wide on findings of non-insider status. Thus, even where parties to a long standing romantic relationship are found to have purchased a claim at huge discount, a factual determination that the transaction was at arms-length may withstand appellate scrutiny.

The future impact of this decision may be seen in Justice Kennedy's concurrence. He had serious doubts about the factual finding by the bankruptcy court. ("[T]here is some room for doubt that the Bankruptcy Judge was correct in concluding that Rabkin was not an insider, *especially without further inquiry into whether the offer Bartlett made to Rabkin could and should have been made to other parties who might have paid a higher price."* (Slip op. concurrence at 2). He cautioned the case should "not be read as indicating that a transaction is arm's length if the transaction was negotiated simply with a close friend, without broader solicitation of other possible buyers." *Id*. at 2.

Justice Sotomayor's concurring opinion likewise expressed doubts about the legal standard used by the Ninth Circuit to determine insider status. She wondered why a finding of "arms-length" was determinative. Instead she thought that the test should include whether the putative insider has characteristics similar to the statutory insider list. For example, a relative of an officer of an insider is considered a statutory insider; what then, about one who is not related by law, but has an active, close romantic relationship? She also wondered about the integrity of the system where one who was romantically connected could buy a claim without due diligence and without any inquiry into whether fair value was given. She stated that under a modified test she may have found that Rabkin was a non-statutory insider.

These two concurring opinions may give some pause to any ultimate sense that debtors have free rein to sell their insider claims to close friends and then suddenly have an assenting class. The Court seemed to be strongly signaling that it might not countenance such an outcome. However, those issues were not technically before the Court and so its musings remain just that—food for thought.

**<u>Per plan versus per debtor confirmation: cram down of mezzanine lenders</u>**.

One impediment to a successful real estate bankruptcy case is the existence of a mezzanine debtor, which typically has a lien on the mezzanine borrowers interest in the operating debtor. If so, the mezzanine debtor may be able to foreclose quickly and thus extinguish the right of the former owners of the operating entity to file for bankruptcy. To stop this foreclosure, the mezzanine owners would need to file a bankruptcy at the mezzanine level. However, a mezzanine level bankruptcy case is typically difficult, since such entities are likely to have only one creditor, namely, the mezzanine lender. Without a second class to vote for a plan, the mezzanine borrower has little chance of surviving a motion to dismiss the bankruptcy case.

This outcome, however, may be avoided if the operating debtor can (a) file a bankruptcy petition for both entities; (b) submit a consolidated plan and (c) argue that the voting requirements need only be established by one debtor not both. That is, a real estate owner can argue that the Code requires an assenting vote on a "per plan" basis and not a "per debtor" basis.

The Code requires that in order to confirm a plan of reorganization, at least one class of impaired creditors have accepted the plan. 11 U.S.C. § 1129(a)(10). In *JPMCC 2007-C1 Grasslawn Lodging, LLC v. Transwest Resort Properties Inc., (In the Matter of Transwest Resorts Properties, Inc.)* 881 F.3d 724 (9th Cir. 2018) the Ninth Circuit in a case of "first impression" among the circuit courts held that §1129(a)(10) applies on a "per plan" basis. This ruling will now make confirmation of real estate cases substantially easier for any case in which there are consolidated debtors. This is an important decision as it may make mezzanine loans now subject to cram down and plan confirmation, whereas prior to this, a mezzanine borrower bankruptcy was rarely feasible.

No further appellate activity appears to be pending or permitted.

**<u>Cram down interest rate.</u>**

Assuming the debtor has the requisite votes to approve a plan of reorganization, the substantive terms of the plan must still satisfy the other confirmation standards. The most pertinent standard is the obligation that a plan provide a secured lender with the present value of its allowed secured claim, even if paid over time. 11 U.S.C. § 1129(b).

Another key question for all lenders and debtors is the required rate of interest that a debtor must pay when it seeks to confirm a plan of reorganization that restructures its secured loan. In *Till v. SCS Credit Corp.* 541 U.S. 465 (2004) a plurality of the Supreme Court held that the bankruptcy courts should use a "formula" approach, as opposed to looking to the market place to try to determine what the applicable market might demand as the prevailing interest rate. Under this formula approach, the Supreme Court generally stated that a court should begin with the national prime rate, and then add interest as needed to account for perceived risk factors. However, the Court indicated that generally this would lead to a rate of interest of one to three percentage points above the national prime rate and that "eye popping" rates were to be avoided. Because *Till* was a Chapter 13 consumer case, the Court noted in a footnote that in a Chapter 11 case, if there was an "efficient market" for cram down loans, a bankruptcy court could then look to such a market and not use the formula approach. Nevertheless, Justice Stevens who wrote the opinion stated that ordinarily the same rate of interest test should be used in all chapters of the Code. For the last 14 years the question has remained whether *Till* requires use of the formula approach in a commercial chapter 11 case.

In *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. 2015), *aff'd* 531 B.R. 321 (S.D.N.Y. 2015) both the bankruptcy court (Judge Drain) and the district court held that it was unlikely that efficient markets existed for cram down loans and that the formula approach should be used.[8] The Second Circuit disagreed and remanded the case back to Judge Drain to make a determination of whether there was an efficient market, and if so, to apply that rate. Thus, while a part of Judge Drains' decision on the make whole is now the subject of petition for review by the Supreme Court, the issue on the appropriate rate of interest is on remand.

**Current status.** The matter is still pending before Judge Drain. Trial is set for August 22-24, 2018. The parties are in the midst of expert reports and discovery.

**Make-whole payments.**

Another substantive requirement of plan confirmation and cram down, is that the lender receive the present value of its allowed claim. A persistent question in bankruptcy has been whether the allowed claim includes monies due under a "make-whole" provision. A similar issue arose many years earlier under the notion of "pre-payment premiums." Some courts held that they could not be enforced following default. "No doubt prepayment premiums are the price of "an option voluntarily to prepay the loan and terminate the mortgage before the maturity." *In re S. Side House, LLC,* 451 B.R. 248, 267 (Bankr. E.D.N.Y. 2011). It may be that the shift to "make whole" provisions was designed to avoid this earlier outcome and to make the obligation continue past default.

In *Momentive Performance Materials, Inc., v BOKF, NA (In the Matter of MPM Silicones, LLC),* 874 F.3d 787 (2d Cir. 2017), a "make whole" provision was described as a contractual promise to pay the lender a fee if the loan is refinanced *prior* to maturity, thus depriving the lender of future interest.

The Second Circuit held that the make-whole provision was not triggered where the debtor sought to refinance the notes as part of its plan of reorganization, relying on New York state law. The loan documents provided that the fee was due if there was an "optional redemption." The lenders argued that the debtor's refinancing was optional, because under bankruptcy law, the debtors could have retained the bonds. The debtor, however chose to refinance in order to take advantage of the lower interest rate. The bankruptcy court, district court, and Second circuit all held that the bonds were technically defaulted when Momentive filed for bankruptcy, and hence the refinancing was not "optional."

The term "redeem" was held to mean a repayment of a debt at or prior to maturity. However, the filing of a bankruptcy petition triggers a default, and changes the date of maturity of

[8] *See* David Kuney, "The Myth of the Efficient Market." ABI Journal, __ 2018.

the note to the petition date. Thus, the payment under the plan was a "post maturity" payment and not a redemption.  Accordingly, the make whole was not a "redemption." It was also not "optional" because the obligation to pay came about automatically by operation of an automatic acceleration clause which made the bankruptcy filing an event of default and triggered acceleration of the notes.

A petition for writ of certiorari was filed on March 14, 2018 asking the Supreme Court to review the make whole issue.  However, on June 18, 2018, the Supreme Court declined to grant certiorari.

**By David R. Kuney**