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Interest Rates and Cram Down: Recent Supreme Court Case Determines Appropriate Rate in Chapter 13 Cases

Since United States Supreme Court decisions in Bankruptcy cases are rare, practitioners take notice when a decision is issued. By the slim margin of 5 to 4, the Supreme Court recently held that the appropriate interest rate to compensate a secured creditor for the present value of a stream of deferred payments in a Chapter 13 case is the 'formula rate' - a rate arrived at by taking the national prime rate and then making an appropriate upward or downward adjustment.

The Court's decision in the case of Till v. SCS Credit Corp.,[1] addressed the failure of the Bankruptcy Code to provide for a specific interest rate in Chapter 13 cases where the debtor's plan "crams down" a secured creditor's claim. A "cram down" occurs when a plan is confirmed over an objecting class of creditors.[2]

The Till decision is significant since it resolves an unsettled issue in Chapter 13 cases. Furthermore, the analysis undertaken by the Court may begin to be utilized by Courts in Chapter 11 cram down cases. The fact that the case was decided by the simple majority highlights the controversy surrounding this issue.

The facts in Till were straightforward. The debtors defaulted on an installment contract for the purchase of a used automobile. The contract contained a finance charge of 21%. Almost one year after entering into the contract, the debtors failed to make the required payments and subsequently filed a Chapter 13 Petition. As part of their repayment plan, the debtors proposed to pay the secured creditor's claim over time with interest at a rate of 9.5%. The 9.5% interest rate proposed by the debtors represented the national prime rate plus a premium to account for the risk of nonpayment. The secured creditor objected to the debtor's plan asserting that it was entitled to a repayment of its claim at the contract rate of 21%.

In rejecting the secured creditor's argument, the Supreme Court identified three factors to support the use of the formula rate: (i) the Bankruptcy Code requires a court to discount a stream of deferred payments back to their present dollar value and Congress would likely favor a method to accomplish this that minimizes the need for expensive evidentiary proceedings; (ii) Chapter 13 expressly authorizes a bankruptcy court to modify the rights of a creditor whose claim is secured by an interest in anything other than the debtor's principal residence; and (iii) from a creditor's point of view, the cram down provision requires an objective analysis. The Court held that the formula approach best served the purposes of the Bankruptcy Code since it was straightforward, minimizes the need for evidentiary proceedings, and relies only on objective factors such as the state of financial markets, the status of the bankruptcy case, and the characteristics of the loan.

The Court's decision in this case represents what may also be an important development to secured creditors in Chapter 11 cases. Since the present value analysis of a stream of deferred payments is substantially the same in both Chapter 13 and Chapter 11 cram down cases, it is important for secured creditors in Chapter 11 cases to understand the implications of the Court's holding. As noted in the dissent of Justice Scalia, the formula approach "will systematically undercompensate secured creditors for the true risks of default[,]" an assertion that should concern secured creditors in Chapter 13 or Chapter 11 cases.

The fact that a formula rate will be applied to a secured creditor's claim in Chapter 13 cram down cases will impact a secured creditor's decision whether, and under what conditions, it will lend to a borrower. A secured creditor must anticipate that a higher contract interest rate on subprime loans may be replaced with a formula rate if a debtor files for bankruptcy and then attempts to cram down the secured creditor's claim. As Till illustrates, the difference between a presumptive contract rate and a formula rate can be significant—9.5% versus 21%. A secured creditor in a cram down situation must thoroughly ana-

lyze the risk of nonpayment if it hopes to convince a Bankruptcy Court to apply an interest rate approaching the contract rate.

The positions held by the majority and the dissent are noticeably incompatible. The majority begins from a low base interest rate and then requires the creditor to present evidence supporting a higher rate to compensate for the risk of nonpayment. The dissent begins from a high presumptive contract rate and then requires the debtor to present evidence supporting a lower rate. The division among the Justices reflects a disagreement over the meaning of "value, as of the date of the plan." However, unless Till is superseded by statute, a secured creditor in a Chapter 13 cram down case should expect Bankruptcy Courts to authorize a debtor to apply a formula interest rate to a stream of deferred payments despite the objection of the secured creditor.

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[1] 124 S. Ct. 1951 (2004).
[2] See 11 U.S.C. §1129(b).

Collateral Close-up

"It was the best of times, it was the worst of times . . . ." Dickens surely was not contemplating the mindset of a creditor faced with a secured financing in default. But the sentiment is fitting; for although no one looks forward to a default, a secured deal gone bad presents the lien holding creditor with a unique opportunity to realize on collateral ahead of others and thus secure real value on its debt. Of course, no two deals, and no two defaults, are alike. Following three simple rules, however, will arm the secured creditor with the foundation necessary to maximize recovery in a default situation.

1. ***Know your facts***. Certain remedies are generally available only upon the occurrence of a default or an "event of default" on the debt. In order to take advantage of the benefits afforded by a security interest, it is imperative that the secured creditor familiarize itself with the circumstances that have transpired to create a default under its operative documents. Was the default triggered by the breach of one of more covenants, the failure to make scheduled payments, the filing of a bankruptcy petition or a combination thereof? Each of these scenarios presents unique challenges that will need to be considered in making decisions relating to the collateral. For example, the automatic stay imposed at the inception of a bankruptcy will prohibit any action with respect to the collateral other than that approved by the bankruptcy court. Similarly, the controlling documents may provide that nonperformance of a covenant only becomes an actionable default after notice or the passage of time, thus preventing any immediate action regarding your collateral. In addition, while natural instincts of a creditor in a default situation may be to immediately avail itself of all available remedies, it is important to consider, albeit as quickly as possible, whether efforts to amicably work out the debtor's troubled financial circumstances might lead to a better recovery than precipitous actions to foreclose. Once informed of these and other facts concerning the defaults at issue, the secured creditor can begin to identify its options vis-à-vis its collateral.
2. ***Know your documents***. The operative documents in any transaction (as well as Article 9 of the Uniform Commercial Code) govern the secured creditor's rights and remedies following a default. These documents should be the starting point for understanding the scope of one's security interest and the nature of one's collateral, and will articulate any limitations, restrictions or conditions to the secured creditor's exercise of remedies, including the enforcement of a security interest. The operative documents should be consulted often throughout the life of the default for guidance on things such as the disposition of collateral, the distribution of any resulting proceeds and the relationship with and effect on other lien holders.
3. ***Know your collateral***. The decision of whether, and in what manner, to exercise one's security interest is largely dependent upon the nature of the collateral at issue. It makes a big difference whether the collateral is a build-

CREDITORS' RIGHTS QUARTERLY

The Members of the Bankruptcy Group at Shipman & Goodwin LLP are as follows:

Ira H. Goldman	telephone: (860) 251-5820 email: igoldman@goodwin.com
Julie A. Manning	telephone: (860) 251-5613 email: jmanning@goodwin.com
Kathleen M. LaManna	telephone: (860) 251-5603 email: klamanna@goodwin.com
Andrew M. Zeitlin	telephone: (203) 324-8111 email: azeitlin@goodwin.com
Jennifer L. Adamy	telephone: (860) 251-5811 email: jadamy@goodwin.com
Corrine L. Burnick	telephone: (860) 251-5614 email: cburnick@goodwin.com
Hanh V. Huynh	telephone: (860) 251-5909 email: hhuynh@goodwin.com
Patricia Gagnon Paralegal	telephone: (860) 251-5822 email: pgagnon@goodwin.com
Lisa Weeden Paralegal	telephone: (860) 251-5932 email: lweeden@goodwin.com

ing, an airplane, a windmill, cattle (yes we mean cows), cash, intellectual property, or perishable inventory. Immediate action may not only be advisable, but necessary. On the other hand, immediate action may hasten the demise of the debtor in a bankruptcy scenario or otherwise impair an obligor's ability to generate cash flow and service its debt, ultimately leading to a lower recovery for a secured creditor. Other factors to consider in making decisions regarding collateral include value (which may not be readily ascertainable without the assistance of financial or other advisors) and the natural consequences of a plan(s) of action; although foreclosure may seem a likely reaction to the default, does a secured creditor really want to become the beneficial owner of cattle herds or railcars?

It is clear from the foregoing discussion that decisions regarding collateral must necessarily be made on a case by case basis. The only universal maxim is that, as a secured creditor with a deal in default, one must quickly size up your collateral and then proceed, prudently, in accordance with your documents, and after considering alternatives and consequences, to make the most out of being a secured creditor.

Pre-Petition Judgments, Appeals and the Automatic Stay

It is often the case that the entry of a sizeable judgment against a party to a lawsuit will force that party to seek protection under Chapter 11 of the United States Bankruptcy Code (the "Code"). Sometimes, a judgment against an already financially troubled company is simply the last straw, and the company turns to the Code to buy time that will allow it to reorganize by restructuring its debts without the pressure of a looming judgment that could otherwise force the company out of business altogether. A bankruptcy filing gives the debtor/company immediate protection from the judgment creditor by reason of the automatic stay provision of the Code, which stops all collection efforts, including the enforcement of a judgment obtained before the commencement of the bankruptcy case.

In the early stages of a Chapter 11 case, a debtor company that has now become a "Debtor-in-Possession" under the Code must focus on numerous administrative and other requirements attendant to an orderly reorganization. These priorities, such as preparing and filing schedules, obtaining debtor-in-possession financing and seeking appropriate court orders to ensure the company's ability to operate during the bankruptcy proceedings, require immediate action, often to the exclusion of other matters — including decisions regarding whether to appeal a pre-petition judgment.

A significant problem can arise if the debtor waits too long before filing a notice of appeal from a pre-petition judgment. Specifically, non-bankruptcy law fixes time limitations for taking an appeal, and a failure to appeal within such limitations may result in a judgment becoming final. A final non-appealable judgment can represent the creditor's allowable claim in the bankruptcy proceedings.

Relief from such a harsh result can be found in Section 108 of the Bankruptcy Code, which extends certain limitations periods.[1] However, the length of such an extension may depend upon where the bankruptcy case is pending. Section 108(b) generally extends the period for filing "any pleading, demand, notice, or proof of claim or loss, cure a default, or perform[ing] any other similar act," for up to 60 days from the commencement of the bankruptcy case. Section 108(c) generally extends the time "for commencing or continuing a civil action in a court other than a bankruptcy court on a claim against the debtor," until 30 days after the automatic stay under Section 362 of the Code terminates or expires.

There is little circuit court authority as to which of these provisions applies to a debtor's appeal from a pre-petition judgment. The Second Circuit recently addressed the question directly in Local Union No. 38, Sheet Metal Workers' Int'l Assn. v. Custom Air Systems, Inc.[2] In Local Union No. 38, the court found that section 108(b) applies to an appeal from a pre-petition judgment. The court held that a notice of appeal is timely filed if the time limit for filing an appeal has not expired before the bankruptcy filing and the notice of appeal is filed no later than 60 days after the commencement of the bankruptcy case.

However, certain language in an earlier decision by the same court raises questions about the soundness of that ruling. Specifically, in Teachers Insurance & Annuity Assn. of America v. Butler,[3] the Second Circuit acknowledged that the automatic stay under Section 362 of the Code applies to a debtor's appeal from a pre-petition judgment, finding that an appeal constitutes a continuation of judicial proceedings against the debtor. The holding in Teachers Insurance & Annuity Assn. is significant because it suggests that the taking of an appeal is more reasonably governed by the language in Section 108(c), which, if it applied, would provide for a longer extension of time than 108(b). If Section 108(c) applies, the debtor may have until 30 days after the confirmation of a plan of reorganization, which may occur many months, if not years, after the case was commenced. If Section 108(b) applies, as was the case in Local Union No. 38, the debtor has only until 60 days after the commencement of the bankruptcy case to file its notice of appeal.

In a recent case in the Eighth Circuit, the court made the direct correlation between the automatic stay provisions of the Code and the extensions of time contained in Section 108. In the case of Bunch v. Hoffinger Industries, Inc.[4], the court held that deadlines for filing an appeal from a pre-petition judgment must be extended pursuant to Section 108(c) and not 108(b). Thus, the Hoffinger court held that time for filing an appeal of a pre-petition judgment is until at least 30 days after the termination of the automatic stay.

Although not presently on appeal, the inconsistent rulings in Local Union No. 38, Teachers Insurance & Annuity Assn., and Hoffinger could require United States Supreme Court review on this issue.

[1] 11 U.S.C. §108.
[2] 333 F.3d 345 (2nd Cir. 2003).
[3] 803 F.2d 61 (2nd Cir. 1986).
[4] 329 F.3d 948 (8th Cir. 2003).

Nationwide Electronic Access to and Filing of Documents in Bankruptcy Cases

Shipman & Goodwin LLP's Bankruptcy Group represents clients in bankruptcy cases throughout the United States. Our representation includes cases filed in Connecticut, New York, Delaware, California, Massachusetts, Arizona, Texas, Hawaii, Oregon and Florida, just to name a few. Our ability to represent clients on a nationwide basis has been made more efficient by programs that allow for the electronic filing of documents. Starting in 1994, the United States Bankruptcy Courts became the "test" courts in the Federal Court system for electronic access to and filing of pleadings. At first, only a few selected Bankruptcy Courts had the capacity to allow people to electronically access and file pleadings. Over the last ten years, however, the overwhelming majority of Bankruptcy Courts have joined the select few and now over 90% of all Bankruptcy Courts operate electronically.

In 1994, Shipman & Goodwin LLP became one of the first law firms in Connecticut to have access to electronic dockets and electronic filing privileges. As more and more Bankruptcy Courts have joined the first test courts in adopting electronic filing, it has become imperative that attorneys register with these courts for filing privileges. By converting a word document to what is known as a "PDF file", one can easily file documents electronically with the Courts. Once filed electronically, pleadings appear on the court docket almost instantaneously.

In most courts, service of pleadings can also be made electronically. Any document electronically filed in a case will immediately and automatically be sent via email and will generally be received within one-half hour of the document being filed with the Court.

Electronic filing and service of pleadings is here to stay. It is certainly the wave of the future.

One Constitution Plaza
Hartford, CT 06103-1919