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DETERMINING THE APPROPRIATE INTEREST RATE UNDER *TILL* IN A BANKRUPTCY CASE

By C. Paul Wazzan¹, Ph.D., Keith Mendes² and Gabriel Green³

Abstract

Under certain circumstances, the method of determining an appropriate rate of interest to be applied in a bankruptcy case is guided by the principles laid out in the United States Supreme Court's decision in *Till v. SCS Credit Corp.* which establishes a formula approach, beginning with the Prime Rate and then considering: 1) the circumstances of the bankruptcy estate; 2) the nature of the security; 3) the duration of the reorganization plan; and 4) the feasibility of the reorganization plan. The Supreme Court decision does not specify exactly what is to be considered when applying these four factors. This paper attempts to overlay economic principles on the *Till* decision and provide legal scholars and practitioners with a formal (though not necessarily exhaustive) list of economic variables to consider under each factor.

I. Introduction

One important element of most Plans is typically the restructuring of the outstanding secured debt, including the determination of the appropriate interest rate on that debt. Frequently, the interest rate is not one that can be observed or obtained in "normal" non-bankruptcy markets—the debtor in possession ("DIP") is already in bankruptcy and not likely to meet the underwriting criteria of lenders in that market. In other words, it is not common for debtors in bankruptcy to have access to such capital. As a result, the Court may require expert analysis to determine what would be a new appropriate interest rate for the outstanding debt assuming the Plan is otherwise confirmable. For those Plans that are confirmed, which contain a new interest rate on the debt, the lender, as a creditor of the estate, is then forced to accept the new interest rate—commonly referred to as a

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"crammed down" or "cram down" loan on the lender. This paper focuses on this particular aspect of a restructuring (i.e., non-liquidation) bankruptcy case, where a Court is put in the position of determining whether a proposed interest rate is appropriate for a secured claim and the Plan is confirmable.

Ultimately, while *Till v. SCS Credit Corp.*⁴ outlines a general framework of factors (often referred to as the "formula approach") it does not provide specificity as to what variables should be considered under each of these factors, nor how the cram down rate should actually be computed. This lack of specificity has led some courts to reject the formula approach in favor of other methods including the coerced loan rate, the presumptive contract rate, and the cost of funds rate.⁵ Moreover, the variables or parameters that make up "the circumstances of the estate" are likely to be quite varied. A recent court decision stated the following:

(Expert's) testimony was more credible and consistent with *Till* guidelines. Expert considered factors such as the DIP's property was a high-end project, in operation with a high level of occupancy (98%). He amortized the initial Bank loan which ironically was set at prime plus .25%, even though a series of modifications (except for the final two). He considered the long time history of the builders and the continuity of management. Moreover, he gave consideration to the three (3) year terms of the reorganized loan-saying the shorter the term, the lower the interest rate. An inflationary factor was minimal, due to prime rate which set consideration of such factor. Lending practices of the Bank were considered, loan to value ratio and debt service ratio, for which he made adjustments. This list is not inclusive, but is sufficient to indicate a careful consideration of all factors in accordance with the *Till* formula, and then concluded the plan repayment . . . was feasible due to the financial condition of the DIP.⁶

Setting aside the ongoing legal debate, and consistent with the formula approach advocated by *Till*, in the following sections we apply economic rigor to

⁴ *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

⁵ *See id.* (Stevens, J., Plurality)

⁶ Memorandum Decision, *In re Caviata Attached Homes, LLC*, 09-52786-gwz (Bankr. D. Nev. Apr. 12, 2010), ECF No. 152.

the *Till* decision in order to provide legal scholars and practitioners with a specific list of variables to consider under the formula rate approach (not all of which are necessarily required for each analysis) and the reasoning behind each variable and how it might affect the determination of the post-confirmation interest rate.

II. Circumstances of the Estate

The term "circumstances of the estate" is not defined by the Supreme Court. It can be reasonably taken to encompass any issue that will impact the reorganized debtor's ability to service the loan, or affects the risk of the loan. The characteristics then of the borrower as well as factors affecting risk should be considered under this first factor.

A. Market Rates as a Starting Point

Commercial loans are often colloquially described as "story loans" in that a lender needs to hear the complete story behind the planned borrowing in order to determine an appropriate interest rate. Nevertheless, generally available rates for comparable loans, for comparable projects, for comparable borrowers are likely to be a good indicator of the market's current assessment of the appropriate risk adjusted interest rate. These rates, or approximations, can sometimes be obtained through direct discussions with banks. In our experience, lenders typically indicate that the final rate will depend on the characteristics of both the borrower and the completed project and that pro-forma financials play a significant role in the determination of the final interest rate. Use of this benchmark data in conjunction with the Prime Rate may allow the practitioner to determine a starting point for the analysis.

B. Characteristics of the Borrower

The characteristics of the borrower, and ultimately its guarantors, are important factors. For example, if the borrower is a well-established developer with a substantial history of successfully completing projects, the risk may be considered to be less than that for a relative novice. Similarly, borrowers that have shown the historical ability to adapt their business model to changing environments may also pose less risk. Moreover, one should consider if the guarantor is sufficiently able to retire the loan in part or in full. Where the guarantee is strong, the risk can be considered as reduced.

C. Industry Considerations

The overall state of the industry in which the borrower operates can be

informative. For example, if the borrower is a developer of commercial office space and the industry is projecting softening demand over the next two years, then the risk could be considered as increasing. The converse would also be true. This analysis can be done on a local level, state level or nationwide level—depending on the specifics of the particular loan. Such analyses might also consider an evaluation of the current quantity and quality of the reorganized debtor's competition plus the potential for new entrants.

D. Initial Loan Terms Agreed to by the Borrower

Before one can consider the factors affecting risk, it may be useful to determine the risk as initially defined by the lender at origination. Interest rates are set on a case by case basis based on various factors included but not limited to: (i) existing relationships with the borrower, (ii) credit history/rating, (iii) nature of the project, (e.g., building type, projected income) (iv) market competition, and (v) the size of the loan.⁷ The terms obtained prior to the bankruptcy are likely to be informative as to the perceived risk. For example, if the initial loan was made at Prime plus 1%, one might consider that the project specific risk equates to 1%, barring changes in the market since origination. Implicit in this assumption is that the Prime Rate accounts for overall market risk.

E. Type of Loan

Some loans are inherently riskier due to the nature of the project being funded by the loan. For example, certain construction loans involve numerous factors such as the project being completed in the expected time frame, being completed at the expected cost, and the borrower securing long term financing for the project upon completion. Other asset-based loans or long term financing (e.g., for a completed building) may not carry these risks and may therefore warrant a lower interest rate—other factors remaining constant. Interest only loans with balloon payments require the reorganized debtor to have or create the financial capacity to make more than just the monthly payments, which presents additional risk to the lender. In short, the type of loan will factor into a determination of the appropriate interest rate.

⁷ ("At Cal National, we understand that a "one-size-fits-all" approach to commercial lending just doesn't work. We employ real people to make loan decisions and customize financing to suit your financial needs. We offer fixed and adjustable rate financing at competitive rates and flexible terms.") California Nat'l Bank, <http://www.calnational.com/commercial-real-estate/>. (Last viewed Feb. 22, 2010).

F. Post Confirmation Ability of the Borrower

The impact the pending reorganization has on the reorganized debtor's ability to borrow money, undertake "normal" business activities, and sell property should be taken into consideration. If the terms of confirmation will inhibit the reorganized debtor's ability to raise capital, then the loan may pose a greater risk than one under which those abilities are retained.

G. Lender Offered Terms

Loan terms for contemporaneous non-bankruptcy projects are often available directly from the actual pre-bankruptcy lender or various competing lenders and can be directly observed. For example, a review of terms being offered by the lender might indicate that commercial real estate loans greater than \$25 million were available under the following terms:

- Property Type: Office, Retail, Industrial, Self Storage
- Loan Fee: 1%
- Loan Amount: \$500,000- \$25,000,000+
- Term: 10 years
- Amortization: 25 years
- Loan To Value Ratio: 75%
- Debt Service Coverage Ratio: 1.25
- Recourse: Recourse
- Rate: Libor +2%
- Processing Fee: \$750 or 10bps, whichever is greater
- Third-party Fees: Actual, to be determined (environmental, title, closing costs, etc.)
- Prepayment Fee: Varies

These terms may reasonably be considered by the expert in developing an opinion as to the appropriate rate. For example, if the post-confirmation loan were to conform to each of the above stated conditions then it is unlikely (barring other complicating factors) that the post-confirmation terms would be much different.

III. Nature of the Security

Till indicates that the collateral used to secure the loan should be carefully considered. Such an evaluation encompasses the value of the collateral relative to the loan and assesses the risks associated with the collateral itself.

A. Characteristics of the Project and Project Specific Risks

The collateral is typically the property itself. Issues to consider include the property's status relative to its competition (e.g., in construction one might consider whether the project is high or low end, occupancy rates, rental rate trends, rental rates relative to market averages).

B. Status of Property

The current status of the property will factor into risk. Consider a situation where the owner of a parking lot has seen revenues fall because of unrelated temporary road construction. Demand for parking is expected to be unchanged—the cars simply cannot access the lot at present, but that circumstance is likely to change in relatively short order. Consequently, one may expect the risks to be somewhat mitigated by the fact that the economics of the loan are basically unchanged—they are simply subject to a temporary delay.

Similarly, all things being equal, a construction project that is completed or near completion may be considered less risky than a project in an earlier stage of development.

C. Loan to Value Ratio

The loan-to-value ("LTV") ratio measures the outstanding amount of the loan against the lower of either the price or the appraised value of the collateral. A borrower with a higher loan-to-value ratio has committed less of its own equity towards the project and the lender is subject to greater risk from unforeseen price movements (e.g., the value of the collateral may fall).

D. Liquidity of the Collateral

Liquidity is defined as the capacity of an asset to be converted easily and with minimum loss into cash. U.S. Treasury issues (including Bonds, Notes and Bills) are generally considered the benchmark liquid investment. A liquid market is one in which there is enough activity to satisfy both buyers and sellers. The liquidity of the collateral used to secure the loan is an important element in the determination of risk. For example, if the loan was used for the development of a condominium project and the supply of unsold condominium units currently exceeds demand, one might consider the collateral to be illiquid. Conversely, if the loan was used to acquire capital equipment that is easily sold, then one might consider the collateral to be liquid. This analysis is important as it will determine the ability of the lender to be repaid on the loan (by transforming the collateral

into cash) within a short period of time. The longer it takes, the greater the risk to the lender that the asset may become impaired in some way.

IV. Duration of the Repayment Terms Under the Reorganization Plan

This element of the *Till* decision encompasses risks and other factors that are associated with the length of time provided under the Plan for repayment of the loan.

A. Term and Duration of the Loan

All things being equal, loans of shorter duration typically have lower interest rates.⁸ This is readily observed in mortgage rates (e.g., 30 year loans have higher associated interest rates than 5 year loans) and treasury markets where T-bills (maturities up to one year) have lower yields than T-notes (maturities between two and ten years) which have lower yields than T-Bonds (maturities between 20 and 30 years). This is due, in part, to the uncertainty of future events as well as inflation risk. In other words, investors expect to be compensated for tying up their money for longer periods of time.

The cram down interest rate should therefore reflect the expected or effective duration of the loan. For example, suppose the actual loan (pursuant to the reorganization plan) matures in three years. This would set the maximum duration but not necessarily the expected duration. It may be that the reorganized debtor, with some degree of probability, could refinance or sell the property (and pay off the loan) well in advance of the maturity date.

B. Term Structure of Interest Rates

The term structure of interest rates is a standard metric used in bond valuation and in the analysis of the market for fixed income securities. It is constructed by observing yields against respective maturity dates of benchmark (e.g., US Treasuries) fixed-income securities. To illustrate, Table 1 shows US treasury yields in February/March 2011⁹:

⁸ The reverse, called an inverse yield curve, is considered aberrational.

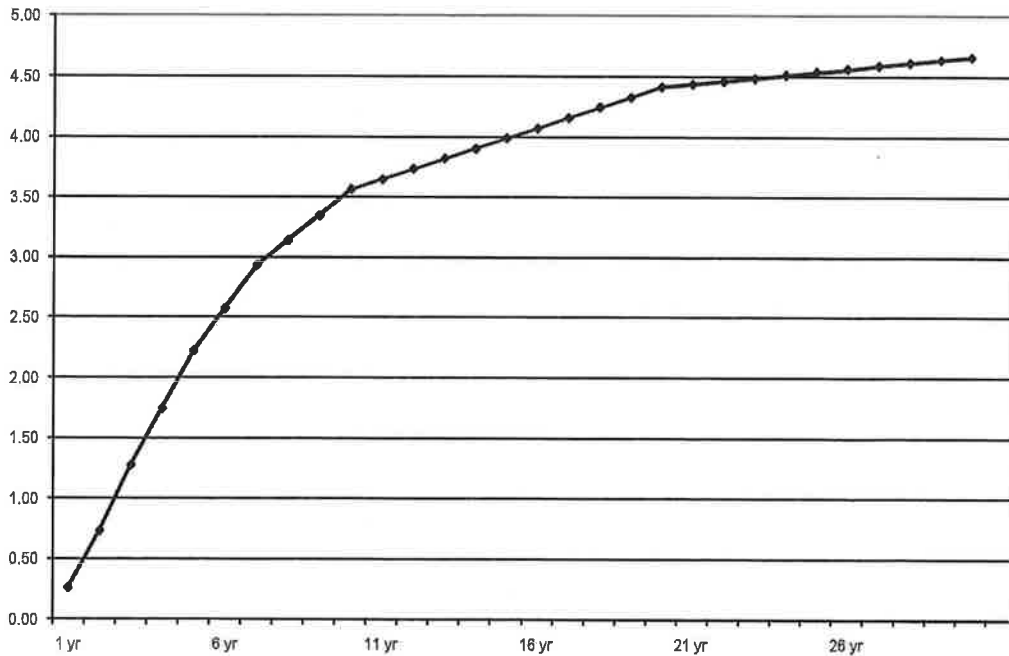
⁹ U.S. Dept. of Treasury, <http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml> (last visited Mar. 9, 2011). The yield curve is a graph that plots the relationship between yields to maturity and time to maturity for bonds of the same asset class and credit quality. The plotted line begins with the spot interest rate, which is the rate for the shortest maturity, and extends out in time, typically to 30 years.

Table 1: US Treasury Yields; February/March 2011

Date	1 mo	3 mo	6 mo	1 yr	2 yr	3 yr	5 yr	7 yr	10 yr	20 yr	30 yr
2/15/2011	0.11	0.13	0.17	0.30	0.84	1.39	2.35	3.03	3.61	4.45	4.70
2/16/2011	0.10	0.12	0.16	0.29	0.86	1.40	2.37	3.04	3.62	4.46	4.67
2/17/2011	0.08	0.09	0.15	0.27	0.80	1.33	2.30	2.99	3.58	4.44	4.66
2/18/2011	0.08	0.10	0.15	0.28	0.78	1.32	2.30	2.99	3.59	4.46	4.70
2/22/2011	0.10	0.12	0.16	0.28	0.74	1.22	2.16	2.85	3.46	4.35	4.60
2/23/2011	0.12	0.12	0.16	0.27	0.74	1.25	2.21	2.89	3.49	4.34	4.59
2/24/2011	0.13	0.13	0.16	0.26	0.73	1.24	2.19	2.87	3.46	4.29	4.54
2/25/2011	0.12	0.13	0.16	0.27	0.72	1.22	2.16	2.84	3.42	4.26	4.51
2/28/2011	0.13	0.15	0.18	0.25	0.69	1.18	2.13	2.28	3.42	4.25	4.49
3/1/2011	0.07	0.14	0.16	0.25	0.66	1.15	2.11	2.81	3.41	4.24	4.48
3/2/2011	0.12	0.13	0.17	0.26	0.69	1.18	2.16	2.86	3.46	4.30	4.54
3/3/2011	0.12	0.13	0.16	0.29	0.79	1.32	2.30	3.00	3.58	4.40	4.64
3/4/2011	0.11	0.12	0.16	0.26	0.68	1.20	2.17	2.88	3.49	4.34	4.60
3/7/2011	0.10	0.11	0.16	0.25	0.70	1.22	2.19	2.90	3.51	4.36	4.61
3/8/2011	0.07	0.11	0.16	0.26	0.73	1.27	2.22	2.93	3.56	4.41	4.66

The term structure is often graphically represented with a "yield curve" which essentially measures the market's expectations of future interest rates given current market conditions. For example, inflationary expectations can be inferred from the curve. The yield curve is effectively a snapshot of investor's beliefs. Figure 1 represents the yield curve derived from the observed yields shown in Table 1:

Figure 1: Yield Curve US Treasuries; February/March 2011



It is apparent from Figure 1 that annual spreads are approximately 0.50% from 1 year through 7 year with annual spreads decreasing significantly thereafter. These rates are consistent with a standard and normal upward sloping yield curve where investors expect to earn higher returns for assets with longer maturities. In other words, the time value of money is approximately 0.50% per annum. The relevance of the yield curve is in its use to assess inflation risk. If inflation risk is high, then the cram down interest rate, all other factors remaining constant, should be higher. Conversely, low inflation risk would result in a lower interest rate.

V. Feasibility of the Reorganization Plan

As a final point, the bankruptcy code entitles the creditor to receive, on account of the secured claim, a present value of the stream of future payments that equals or exceeds the value of the creditor's claim. While *Till* states that the rate decided upon does not need to meet the contract terms at origination (which is the idea behind the cram down), it should not allow businesses to have the opportunity to enter into outlandish deals that an otherwise solvent borrower would not be able to obtain. In short, the creditor should get a fair rate, reflective of actual lending risks.

A. Reasonableness of Underlying Assumptions

A reorganization plan usually requires the debtor to provide pro-forma financial projections and a schedule showing when the debts will be repaid and the source of the funds used for debt service. Plans grounded in fact and supported by reasonable assumptions pose less of a risk than plans based on overreaching expectations and speculation. Items for consideration include, but are not limited to, consideration of the local market, general economic conditions, recent historical earnings, incorporating the characteristics of the collateral, and allowing room for unforeseen expenses. For example, a plan properly incorporating local housing trends/forecasts into the projected earnings of a high-end apartment complex will have a greater chance of success, and pose less risk, than a plan requiring a 50% increase in sales despite recent quarterly decreases and a poor economic outlook to barely cover the proposed debt service. Measuring the accuracy of recent financial projections may also provide insight into the reasonableness of the underlying assumptions.

B. EBITDA

Earnings before interest, taxes, depreciation, and amortization ("EBITDA") is a widely used measurement for the cash flow produced by the

continuing operations of a business. A plan using pro-forma financials with a relatively larger estimated EBITDA indicates the debtor is expecting to generate greater earnings through its normal course of business and presents less risk.

C. Debt Service Coverage

Absolute earnings also need to be measured in context against the amount of the loan. The debt service coverage ratio measures the net operating income, as determined in the plan, in terms of the scheduled debt service over a specific period of time (monthly, quarterly, annually, etc.). A higher debt service coverage ratio indicates the borrower has more financial resources to commit to the repayment of the loan, and thus indicates reduced risk. A debt service coverage ratio of 1:1 means that the borrower is projecting to have funds just barely sufficient to make the debt service payments.

D. Determine Rates Allowable by the Plan

Once a Plan has been developed, a sensitivity analysis can be conducted to determine whether the proposed cram down interest rate will satisfy the net present value requirement, but also allow the reorganized debtor enough margin for error such that the probability of another default is minimized. If the maximum allowable rate determined by the Plan is less than a rate that would provide funds sufficient, at a discount, to meet the net present value requirement, the Plan should be scrapped or reworked. Conversely, simply because the Plan can accommodate certain interest rates does not mean those rates are appropriate for the reorganized debtor.

VI. A Brief Discussion of Temporal Issues to Consider Under Till

The determination of the cram down interest rate takes place *during* the bankruptcy case, but is clearly meant to reflect the appropriate *post*-confirmation interest rate. *Till* clearly states that the coerced loan approach is not acceptable.¹⁰ In a recent case in which one of the author's participated, the Court noted:

¹⁰ There are two variations of the coerced-loan theory. In the first variation, courts "treat any deferred payment of an obligation under a plan as a coerced loan, and the rate of return with respect to such a loan must correspond to the rate that would be charged or obtained by the creditor making a loan to a third party with similar terms, duration, collateral and risk." *Bank of Montreal v. Official Comm. of Unsecured Creditors (In re American HomePatient, Inc.)*, 420 F.3d 599 (6th Cir. 2005). In the second variation the interest rate in a cram down is the same as the creditor would receive if it could foreclose and reinvest the proceeds in loans of equivalent duration and risk. *See, e.g., Koopmans v. Farm Credit Servs.*, 102 F.3d 874, 875 (7th Cir. 1996).

The Court finds and concludes that the testimony of (lender's expert) for the purposes of determining the applicable interest rate for the treatment of Class I under the plan is not appropriate because (lender's expert) bases his report upon a coerced loan approach, contrary to the decision of *In re Till*, 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004), made arbitrary adjustments in increments of 150 basis points without explanation and beyond the parameters set forth in *Till*, made improper calculations as to the loan-to-value ratio and the debt service to income ratio, and determined that the plan was unfeasible based upon the application of his own unreasonably high interest rate. The Court finds and concludes that the testimony of C. Paul Wazzan, Ph.D., the Debtor's expert, is persuasive regarding the applicable interest rate in this case. Dr. Wazzan considered the applicable factors under *Till*, and provided a reasonable explanation for his conclusion.¹¹

In other words, the interest rate determination is not meant to be affected by the debtor actually being in bankruptcy. The analysis should carefully consider the impact of this temporal shift on the final rate.

VII. Conclusion

The determination of the appropriate rate of interest in a bankruptcy case is guided by *Till v. SCS Credit Corp.* which states one should begin with the Prime Rate and then consider: 1) the circumstances of the estate; 2) the nature of the security; 3) the duration of the reorganization plan; and 4) the feasibility of the reorganization plan. Insofar as the Supreme Court decision does not explore the economic variables that actually comprise each of the factors, this paper attempts to overlay economic principles on factors described in the *Till* decision to provide legal scholars and practitioners with a formal (though not necessarily exhaustive) list of those economic variables.

¹¹ Memorandum Decision, *In re Caviata Attached Homes, LLC*, 09-52786-gwz (Bankr. D. Nev. Apr. 12, 2010), ECF No. 152.