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Real Estate Bankruptcy Quarterly Newsletter
July 2018

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A Note to Our Readers

Our goal in creating this newsletter is to provide information and assistance to lenders and servicers with respect to the issues they face in Chapter 11 real estate bankruptcy cases.

Thompson & Knight LLP, established in 1887, is a full-service law firm with U.S. offices in Dallas, Houston, Austin, Fort Worth, New York, and Los Angeles. Our Bankruptcy, Real Estate, and Trial Practice Groups have substantial experience representing lenders and servicers in connection with bankruptcy proceedings; loan modifications; out-of-court workouts; judicial and non-judicial foreclosures; and receivership, guaranty, asset recovery, and other commercial real estate litigation. We hope that you find this newsletter helpful and informative, and we encourage your feedback.

SECOND CIRCUIT LOOKS TO MARKET RATE FIRST TO DETERMINE CRAM DOWN INTEREST RATE

By Katharine Battaia Clark and Bruce J. Zabarauskas

Contractual interest rates may be subject to adjustment in bankruptcy. Where a borrower seeks to "cram down" or make "deferred cash payments" to a secured lender over time as part of its plan of reorganization, the Bankruptcy Code requires that the aggregate of such cash payments be at least equal to the greater of the amount of the secured creditor's claim or the present value of its collateral. To determine whether the aggregate payments are at least equal to the present value of the secured creditor's collateral, bankruptcy courts must determine the adequacy of the interest rate proposed under the borrower's plan.

The Supreme Court's 2004 decision in *Till v. SCS Credit Corp.*, coupled with the market crash of 2008, has complicated bankruptcy court consideration of the issue of appropriate interest in cram down scenarios. The *Till* decision was made in the context of an individual's Chapter 13 bankruptcy proceeding and approved a so-called "formula approach" to determining the appropriate interest rate. Under the formula approach, the bankruptcy court begins with a largely risk-free interest rate (*e.g.*, the prime rate) and determines the proper risk adjustment based on the case at hand.

The *Till* court found the following factors relevant to a risk adjustment analysis: (i) the time-value of money; (ii) inflation; and (iii) the risk of non-payment. The Supreme Court did not consider market rates; however, in a famous footnote, the Court mused that reorganizations under Chapter 11 of the Bankruptcy Code may be different because, in individual bankruptcies, "there is no free market of willing cram down lenders."

While the Supreme Court has not decided a case involving interest rates in bankruptcy since *Till*, several appellate courts and countless bankruptcy courts have taken on the issue. The results have been mixed in Chapter 11 reorganizations, with some courts applying the formula approach from *Till* and others looking first to determine whether there is an efficient market rate of interest. In a recent decision in *In re MPM Silicones*, the Second Circuit[1] adopted a two-step test for determining an efficient market rate of interest in a proposed cram down scenario.

Step one is to determine whether there is an "efficient" market, and step two would be to either apply the market rate or, if there is not one, apply the formula approach from *Till*. The *MPM Silicones* court held an efficient market would offer "a loan with a term, size, and collateral comparable to the forced loan contemplated under the cram down plan."

In the case before the Second Circuit, the objecting secured creditors argued that because the borrower had been quoted interest rates ranging from five to six percent from third-party

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AVOIDING CRAM DOWN IN REAL ESTATE BANKRUPTCIES
PART II: THE PLAN FEASIBILITY FIGHT

By Bruce J. Zabarauskas and Katharine Battaia Clark

In Part I of our "Avoiding Cram Down" series, we discussed the importance of objecting to a borrower's classification of creditors' claims under a plan of reorganization as a means of defeating confirmation of a cram down plan of reorganization. In Part II, we will focus on how the financial feasibility of a borrower's plan of reorganization can be attacked in a cram down scenario.

The Feasibility Requirement

The Bankruptcy Code requires a plan of reorganization to be feasible. A plan proponent must prove feasibility by presenting evidence that "confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." The feasibility requirement ensures that a plan "offers a reasonably workable prospect of success and is not a visionary scheme."[1] The borrower is not required to guarantee with 100% certainty that it will be able to make all payments to the lender the plan contemplates; rather, the borrower must establish there is a reasonable likelihood it will be financially able to make all required payments.

Most cram down plans in real estate bankruptcy cases provide for deferred cash payments to the secured lender over an extended period of time, with a balloon payment due at the end of the repayment period.[2] Borrowers often try to establish financial feasibility at a plan confirmation hearing by introducing evidence that the reorganized borrower will have sufficient cash flow in the future to make all plan payments. This evidence will invariably include financial projections of income and expenses during the plan's repayment period, and may include expert testimony.

The longer the repayment period, the bigger the borrower's challenge to make such a showing and the more incentive a borrower has to dress up its financials through various strategies. Thus, a lender's first line of attack on plan feasibility is the validity of the borrower's financial projections. Lenders should examine the projections and gather evidence of all areas where the borrower has overstated income and understated expenses in order to create the appearance that there will be sufficient cash flow to make all required plan payments.

Challenging the Borrower's Revenue Projections

One common area of weakness in a borrower's financial projections is the projected revenue or income line.

A borrower's financials frequently show increased rental revenues from pre-bankruptcy levels. Any increase must be explored in order for the lender to understand what facts (if any) justify the projected increase in revenues. Future increases in rent must be based on reasonable projections of market rent over time in order to be credible. Expert testimony concerning market rent in the subject property's area is often highly effective in challenging a borrower's financial projections. Even if the subject property is fully leased, market rental rates may be insufficient to support the borrower's projections of the revenue required to make proposed plan payments.

If increased rent is based on a higher occupancy rate, then the borrower should explain the basis for the assumption it will be able to attract new tenants. It is generally insufficient for a borrower to simply state that rental income will increase because the economy will be better in the future. Any other explanations should also be explored. For instance, if the borrower asserts rents will increase because the borrower will be making capital improvements that will attract new tenants at higher rents, then the lender should be asking: (i) whether such capital expenditures appear as expenses in the borrower's financial projections and (ii) whether the projected cost of capital expenditures is reasonable.

Additionally, a property cannot rewrite its rent roll overnight. Leases expire over time, and existing tenants who are timely in paying rent cannot be displaced and replaced with higher-paying tenants at the borrower's will. If the borrower is party to a number of long-term, currently under-market leases, the borrower's financial projections of income should reflect that such rental spaces will continue to be leased below market until the expiration of the current leases' terms. If the borrower's projected financials simply provide that revenues will increase at a particular percentage over time, then such projections are likely lacking a factual foundation because they do not properly take into account the property's existing rent roll.

Similarly, as a practical matter, new leases do not commence the day after existing leases expire, often require concessions to attract new tenants, and do not guarantee new tenants will timely pay rent. There is typically an absorption period between the end of old leases and the beginning of new leases. Lenders should probe whether the borrower's financial projections take into account a reasonable absorption period. Lenders should also inquire whether the borrower's income projections take into account market-driven concessions such as promotional free or reduced rent and whether the projections contain an adequate credit loss reserve that recognizes some tenants will be delinquent in the payment of their rent.

Additionally, more nuanced issues may arise such as properties with aesthetic or functional obsolescence challenges and/or old management being proposed to continue following reorganization. Retaining tenants, raising rents, and attracting new tenants may be impacted by these issues and, thus, lenders and their counsel should investigate and understand whether the property has problems such as insufficient parking, relative inaccessibility, or inactive or incompetent management.

Lenders and their bankruptcy counsel should explore these issues in each case in order to effectively challenge the borrower's revenue projections at the plan confirmation phase.

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AVOIDING CRAM DOWN IN REAL ESTATE BANKRUPTCIES PART II: THE PLAN FEASIBILITY FIGHT

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Challenging the Sources of Cash Infusions

Some projections may show the borrower operating at a negative cash flow for the early years under a plan, and that cash flow will be supplemented by a cash infusion by the borrower's insiders. In such cases, it is important for the lender to insist upon a sufficient showing that the insiders have the financial ability and liquidity to make the necessary advances. Credit checks of the insiders and the insistence on the delivery of the insiders' personal financial statements and proof of the existence of available funds are critical. The lender should also conduct judgment and lien searches on insiders as well as searches to determine if the insiders are defendants in any pending lawsuits.

Challenging the Borrower's Expense Projections

On the expense side, a lender should examine whether the borrower's projected expenses are both complete and reasonable. Borrowers tend to claim that they will operate at lower operating costs than they did pre-bankruptcy. Lenders should ask whether projected reduced operating costs will adversely affect the borrower's ability to maintain and improve the property in order to retain or attract new tenants. A lender's bankruptcy counsel can assist in securing an appraisal report with an analysis of market operating costs for similar properties in the geographic area. This market analysis can be used to impeach the credibility of the borrower's projected expenses.

Additionally, lenders should investigate whether expense projections include capital expenditure, maintenance, and repairs. If so, such projections should be reasonable in light of the current condition of the property. Conversely, if none are included, the projections are likely too low. The borrower's expense projections should also project leasing commissions that are typically due on the commencement of new leases or the date a new tenant begins making rent payments. Moreover, if the borrower converted tenant security deposits pre-bankruptcy and those tenants are projected to exit, the projections should show the return of such deposits.

Expenses such as utilities and real estate taxes that typically increase annually should also be accounted for and should be consistent with historical trends and projections of inflation. Projected insurance costs must be examined to ensure they are consistent with the cost of the type of policies required by the lender's loan documents.

Challenging the Borrower's Proposed Interest Rate

Another cost component that can often be attacked at confirmation is the amount of interest being paid by the borrower during the repayment period. Often the lender can attack the interest rate provided in the plan as inadequate, based upon market conditions and risk of non-payment by the borrower. The validity of a borrower's proposed interest rate is typically challenged through expert witness testimony. If the borrower is required by the bankruptcy court to adjust its interest rate upward, this will increase monthly expenses to the borrower, thereby reducing cash flow available to make payments under the plan.

Challenging Projected Balloon Payments

Borrower cram down plans frequently include a balloon payment at the end of the repayment period because the borrower will be financially unable to make full principal plus interest payments to the secured lender during the plan's repayment period. The borrower's argument in favor of a balloon payment is often that the property will have a sufficient loan-to-value ratio at the end of the plan's repayment period to allow the borrower to then refinance the property and pay off the secured lender with the refinancing proceeds. While the Bankruptcy Code does not prohibit balloon payments, bankruptcy courts tend to give them more careful scrutiny.

Determining the financial ability of a borrower to make a balloon payment is inherently a speculative venture because it requires the bankruptcy court to look into the future to see what the property's value will be. The farther the date of the balloon payment from confirmation, the more speculative that analysis becomes. For example, it is easier to determine whether there will be a sufficient loan-to-value ratio for the property in five years than in 25 years. Hence, the borrower's burden of establishing the likelihood of making a balloon payment becomes more difficult as the repayment period increases. If the lender is able to successfully challenge the borrower's projected income and expenses, the available cash flow from the property will be significantly less than what the borrower projected. This will invariably result in a lower estimate of the property's future value on an income valuation basis and challenge the borrower's contention that the future loan-to-value ratio will support the refinancing of the property and payment of the balloon at the end of the plan's repayment period.

Conclusion

While a borrower is not required to show that it will definitely be able to make all payments under its reorganization plan, it will be required to convince the bankruptcy court that there is a reasonable probability that such payments will be made. While plan feasibility is a somewhat amorphous concept, it is that nature that gives a secured lender the ability to attack plan feasibility from multiple angles. By showing that the borrower has overstated projected revenues or understated projected expenses, the secured lender can assert that the borrower has failed to satisfy its evidentiary burden of establishing that its cram down plan of reorganization is feasible and, therefore, confirmation of the borrower's plan should be denied.

[1] *In re Pizza of Hawaii, Inc.*, 761 F.2d 1374, 1382 (9th Cir. 1985).

[2] The length of the repayment period varies from plan to plan. While not the norm, some courts have permitted repayment periods of up to 40 years in commercial real estate bankruptcy cases.

SECOND CIRCUIT LOOKS TO MARKET RATE FIRST TO DETERMINE CRAM DOWN INTEREST RATE (Continued from page 1)

lenders during the bankruptcy, there was an efficient market and, therefore, the lower interest rate set by the bankruptcy court using the *Till* formula analysis was incorrect. The appellate court in *MPM Silicones* rejected the bankruptcy court's unwillingness to consider evidence that there was a market rate and sent the case back to the bankruptcy court to determine whether an efficient market existed. If so, the bankruptcy court would then apply that rate and would not apply the *Till* analysis.

With the *MPM Silicones* decision, there are now several Circuits that have adopted the interest rate two-step analysis, including those in the Sixth[2] and Fifth Circuits.[3] However, even with the market test gaining steam, the risk of a reduced or cram down interest rate under the *Till* formula approach remains in some jurisdictions.

[1] The Fourth Circuit encompasses Virginia, West Virginia, North Carolina, South Carolina, and Maryland.
[2] The Sixth Circuit encompasses federal courts in Michigan, Ohio, Kentucky, and Tennessee.
[3] The Fifth Circuit encompasses federal courts in Texas, Louisiana, and Mississippi.

Featured Profiles

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