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CONFUSION OVER BANKRUPTCY ESTATE VALUATIONS: A CASE OF LOSING THE FOREST FOR THE TREES


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# CONFUSION OVER BANKRUPTCY ESTATE VALUATIONS: A CASE OF LOSING THE FOREST FOR THE TREES

## I. INTRODUCTION

Debtors who file for bankruptcy relief under the United States Bankruptcy Code (the Code) typically file under one of three chapters: Chapter 7,[1] Chapter 11,[2] or Chapter 13.[3] In Chapter 7 filings, also known as "liquidations," the debtor's assets are sold and the proceeds are split among the creditors, with repayment preference given to secured creditors. On the other hand, bankruptcy plans filed under Chapters 11 or 13, often called "reorganizations," allow the debtor to keep his assets after negotiating the payment terms with the secured party to whom the debtor owes money.

The value assigned to the debtor's assets is critically important in both liquidation and reorganization filings, though the context of valuation is different in each. First, creditors' claims are bifurcated into secured or unsecured status,[4] depending on the value assigned to the underlying assets. Because secured creditors enjoy preferential treatment relative to unsecured creditors when bankruptcy claims are satisfied, and because many unsecured creditors receive little or nothing in the way of debt satisfaction, the value a court places on the debtor's assets often dictates whether, and to what amount, a creditor's loan will be repaid. Valuation in this sense reflects the value that the court assigns to the specific assets involved in the bankruptcy claim.

Valuation also plays a vital role in determining whether a secured creditor's interest in the underlying collateral is adequately protected; this issue must be addressed each time a creditor requests that the court lift the automatic stay created at the outset of a bankruptcy case.[5]

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[1] 11 U.S.C. §§ 701-84 (2000).

[2] *Id.* §§ 1101-74.

[3] *Id.* §§ 1301-30.

[4] *Id.* § 506(a). The bifurcation of a bankruptcy debtor's claim under section 506(a) is the crux of most bankruptcy claims because a secured creditor's claim is only considered "secured" to the extent that the asset serving as collateral on the loan equals the claim itself. If the asset's value drops below the amount of the loan, the creditor is "secured" only in the amount of the lower value of the asset; the amount of the claim that exceeds the value of the asset is then considered "unsecured." This usually results in only a partial satisfaction of the secured creditor's claim.

[5] *Id.* § 362. Immediately upon the commencement of a bankruptcy case, an injunction (referred to as the automatic stay) is created. The automatic stay prevents creditors from attempting to collect individually from the debtor. This

Unfortunately, there are problems with the way courts currently address valuation issues in bankruptcy cases. The first problem is that there are several methods available, but no guidelines indicating which method to apply in specific situations. Consequently, courts in different jurisdictions inevitably apply different methods; thus, the same bankruptcy plan can have a decidedly different outcome in one jurisdiction than if that same plan had been filed in another jurisdiction.

A second problem with bankruptcy estate valuations occurs in the specific context of Chapter 11 and Chapter 13 reorganization plans. Many debtors in reorganization are forced to repay their creditors over a period of time rather than in one lump sum because of the limited financial resources that drive them to seek bankruptcy protection in the first place. When repayment occurs over a period of time, the debtor must include some amount of interest in order to compensate the creditor for (1) the time value of money[6] and (2) the risk that the debtor might not complete all scheduled payments.[7]

The problem arises when the debtor and creditor disagree over the appropriate level of interest to be applied. This argument most often occurs when the court approves a debtor's proposal over a secured creditor's objections, a situation commonly known as a "cramdown."[8] Because courts have neither determined the interest rate that should apply nor agreed on the appropriate calculation that should be used to determine such a rate, cramdown cases represent another source of confusion over how best to value a debtor's assets in bankruptcy.

Two cases, *Associates Commercial Corp. v. Rash*[9] and *Till v. SCS Credit Corp.*,[10] gave the United States Supreme Court the opportu-

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serves two primary purposes: it gives the debtor some breathing room as they attempt to either liquidate or reorganize in an orderly fashion, and it protects the debtors assets, ensuring that the creditors will be dealt with in a fair manner by preventing one creditor from depleting the debtor's bankruptcy estate before the other creditors have a chance at recouping their loans.

[6] The Supreme Court, in *Rake v. Wade*, 508 U.S. 464 (1993), held that when valuing assets in cases invoking the cramdown provisions, the court must apply a discount rate to the proposed repayments in order to arrive at the present value of those payments. *Id.* at 472 n.8.

[7] Although courts are to approve only those reorganization plans in which they feel the debtor will be able to satisfy the repayments required under the plan, many debtors in Chapter 11 and Chapter 13 cases subsequently fail to meet those requirements, leading to a Chapter 7 filing. These cases are often called "Chapter 20" cases by bankruptcy professionals (Chapter 13 plus Chapter 7).

[8] 11 U.S.C. §§ 1129(b)(2)(A), 1325(a)(5)(B)(ii) (2000).

[9] 520 U.S. 953 (1997).

nity to settle the confusion surrounding the cramdown provision, but unfortunately these decisions raised more questions than answers. *Till* in particular, with its meandering 4-1-4 decision, deepened the sense of confusion surrounding the proper method courts should utilize when valuing bankruptcy estates.

Given the increasing number of Chapter 11 and Chapter 13[11] plans filed each year, as well as Congress's preference for reorganization plans over Chapter 7 liquidation plans,[12] there has never been a greater need for the uniform interpretation and application of bankruptcy estate valuations. This Comment will advance the argument that the inconsistencies inherent in the application of the cramdown provisions stem from the confusion that surrounds the concept of bankruptcy estate valuation; only by identifying the correct method for determining the valuation of a debtor's bankruptcy estate can courts consistently and equitably apply cramdown and other secured debt provisions. Part II of this Comment therefore examines the various valuation methods employed by courts today, both in the context of liquidation and reorganization bankruptcy filings. Part III of this Comment addresses the role that cramdown interest rates play in determining the value of bankruptcy estates by examining the Supreme Court decisions in *Rash* and *Till*. Part IV concludes by proposing the appropriate calculations to be performed when assessing both collateral and overall estate valuations in the context of bankruptcy proceedings.

## II. METHODS OF VALUING BANKRUPTCY ESTATES

### A. *The Importance of Valuation*

In the stock market, buyers and sellers actively trade the common and preferred shares of thousands of companies. These shares represent ownership of the company, so the total value of these shares (*market capitalization*) is considered to be a reliable indication of what the company is worth to the interested parties–in other words, its value. No one asks why one party is selling his

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[10] 541 U.S. 465 (2004).

[11] In 2003, 467,908 Chapter 13 bankruptcies were filed nationwide. James J. Haller, *What Till v. SCS Credit Corp. Means for Your Chapter 13 Clients*, 92 ILL. B.J. 478, 480 (2004).

[12] *See* ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 423 (4th ed. 2001). "Reflecting the analysis of the emerging Law and Economics movement, the legislative history and scholarly debates surrounding the adoption of the 1978 Bankruptcy Reform Act evidence a deliberate plan to make Chapter 13 a more attractive bankruptcy alternative, thus encouraging debtors to choose Chapter 13 repayment over Chapter 7 liquidation." *Id.*

shares, or why another is buying hers; we simply assume that each party has assessed his or her situation and has decided to act upon that assessment by buying or selling shares of the company. There is almost always a slight spread between the "bid" (the price received when one sells a share of stock) and the "ask" (the price a purchaser must pay to acquire a share of the stock). Although some of this spread is the commission that a market maker or stockbroker receives for facilitating the transaction, another dimension to the spread exists: participants realize that sellers and buyers enter transactions with different motives and desires, leading them to assign different values to the same asset.

For example, consider two parties, a conservative retiree and an aggressive daytrader, both of whom are considering purchasing shares of the same utility company. The retiree, intending to purchase the stock and hold it for the long term in order to receive the accompanying dividend, might pay twenty-five dollars for a share of the stock. Such an investor might be thought of as purchasing the stock in order to benefit from the income produced by the asset itself; in other words, he is investing in the company as an ongoing concern, not simply for what he can liquidate the stock in the near future. Now consider the aggressive daytrader, who intends to purchase the stock in order to make a quick profit on rumors that the utility company is about to be bought by a competitor at a price much higher than that for which the utility is currently trading. The daytrader buys the stock based solely on what he can liquidate it for in the near term and cares little about what the company or its shares are actually worth as an ongoing concern.

One can imagine the chaos that would ensue if we required all assets, and therefore all companies, to have two or three different values corresponding with the liquidation and going concern values of those assets. The price a purchaser paid for the company would depend on whether the purchaser wanted to hold the security or sell it immediately. Applied to the hypothetical above, such a system would require the retiree and the daytrader to pay different amounts for the same asset simply because they had different intentions for the asset. Such a system would not yield a true value for the company; it would instead produce valuations of assets and companies that would depend largely upon the whim of investors.

This is exactly how the stock market works. The spread between the bid and the ask of a stock, mentioned earlier, is part of what makes this seemingly chaotic system work, at least with regard to the stock market. The spread theoretically allows an asset or company to have different valuations simultaneously. Why, then, can stock market transactions and other free market exchanges

work on such a dual-valuation system, while bankruptcy courts continue to turn away from dual-valuations in search of an ever-elusive absolute valuation for assets and companies? The answer lies, at least partially, in two major differences between free-market exchanges and bankruptcy proceedings that give rise to the different valuation methods inherent in each. First, participants in a free-market exchange are by definition free to walk away from transactions if they feel their interests are not being served.[13] Second, the number of participants in a bankruptcy proceeding are typically far fewer in number than that of a free-market exchange, leading to a distortion of valuations assigned to assets in bankruptcy proceedings.[14] In order for asset valuations in bankruptcy proceedings to become more accurate reflections of the assets involved, bankruptcy courts must recreate the effects of the free-market system to alleviate the valuation distortions inherent in the bankruptcy process and produce accurate asset valuations.

Creditors and debtors are typically at opposite ends of the spectrum when it comes to the valuation each wants placed on a bankruptcy estate. As with the hypothetical utility stock investors, these competing views change depending on the purpose of the valuation, leading to the possibility that two different valuations might conceivably be calculated for the same bankruptcy estate. Though many purposes exist for determining bankruptcy estate valuations, two that affect a vast majority of bankruptcy claims are (1) to determine the extent to which a claim is secured versus unsecured, and (2) the need for a court to determine whether a secured creditor is adequately protected when the secured party attempts to lift an automatic stay.

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[13] *See* Lincoln Nat'l Life Ins. Co. v. Craddock-Terry Shoe Corp. (*In re* Craddock-Terry Shoe Corp.), 98 B.R. 250, 254 (Bankr. W.D. Va. 1988) (holding that reorganization values are best assessed when the transaction is one conducted at "arms length," between a willing buyer and a willing seller).

[14] In general, the accuracy of the valuation of an asset is directly proportionate to the number of participants involved in purchasing and selling that asset. For example, if a seller attempts to sell an asset but only one purchaser bids for the asset, the purchaser has little incentive to offer the full value of the asset as a purchase price, especially if the seller is a motivated or desperate seller. However, if a second purchaser enters the bidding with a higher offer, the first purchaser may be forced to increase her offer to a level that more accurately reflects the value of the asset.

### *B. Reasons Why Bankruptcy Courts Must Determine Bankruptcy Estate Valuations*

#### 1. The Importance of Valuation in Determining the Amount of a Secured Claim

When the purpose of the valuation is to determine the creditor's level of secured interest relative to the total estate, the secured creditor wants the highest possible valuation. This desire stems from the fact that the creditor's claim will ultimately be bifurcated into secured and unsecured claims,[15] with the deficiency (the amount by which the debt exceeds the value of the collateral) being treating as unsecured.[16] The application of this theory often means that the secured creditor recoups only that amount designated as secured, with the balance of the debt (the unsecured, divested portion of the claim) being discharged.

Conversely, the unsecured creditors want the lowest possible valuation on the estate when the valuation is conducted in the context of deciding the level of secured versus unsecured claims, since the amount the debtor will ultimately be able to discharge is inversely related to the valuation established by the court. By obtaining a low valuation, the debtor is able to discharge a higher amount of the debt in question, providing him with greater financial benefits and, ultimately, a more competitive position upon emergence from either bankruptcy or reorganization.

#### 2. The Importance of Valuation When Addressing Adequate Protection and the Automatic Stay

When the purpose of valuation is to determine a debtor's equity value pursuant to the creditor's attempt to lift the automatic stay, the debtor and creditor again find themselves desiring divergent valuations, though in this context their desires are opposite of those described in the previous section. When attempting to lift the automatic stay, the creditor wants the lowest possible valuation for the estate, because a low value reduces the debtor's level of equity and increases the likelihood that the court will lift the stay.[17]

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[15] 11 U.S.C. § 506(a)(1) (2000).

[16] *Id.*

[17] *Id.* § 362(d). The automatic stay provision serves to protect the debtor while she is attempting to begin her financial life anew, hence the phrase "fresh start" is often assigned to the bankruptcy process. Section 362 accomplishes this by preventing creditors from beginning, or continuing, their efforts to collect on any loans made before the bankruptcy petition is filed by the debtor. In addition to

The debtor, on the other hand, desires a higher valuation in this context in order to persuade the bankruptcy court that the automatic stay should remain in place, allowing the debtor to retain (and therefore continue using) the assets in question. In bankruptcy parlance, the debtor is attempting to prove that the value of the estate is sufficient to provide the secured creditor with "adequate protection."[18] At least one court has ruled that the fair market value of the asset(s) is the proper method of valuing bankruptcy estates when deciding whether the secured creditor is adequately protected.[19]

3. The Importance of Valuation in Determining Insolvency

The solvency of the debtor is an issue that arises in specific applications of the Bankruptcy Code. For example, in order for a creditor to show that payments from the debtor to specific creditors constitute preferences or fraudulent transfers, the creditor must first show that the debtor was insolvent at the time the payments were made. If the creditor successfully proves the debtor's insolvency, payments found by a court to constitute preferences or fraudulent transfers will be deemed voidable, thereby bringing those payments back into the funds available to all secured creditors which, in turn, leads to a higher recovery amount for each secured creditor.

Insolvency simply means that a debtor's liabilities are greater than his assets. Therefore, a valuation of the assets must be made in order to determine whether the debtor's liabilities exceed his assets. The following section examines the methods by which a court may value a debtor's assets under a Chapter 11 or Chapter 13 reorganization plan.

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protecting the debtor, the stay protects creditors by ensuring that all claims against the debtor are handled equitably.

[18] *Id.* § 361. The doctrine of "adequate protection" complements the automatic stay provision discussed in note 17, *supra.* If the valuation assessed by the court is too low, the creditor may succeed in persuading the court to lift the automatic stay. This protects the creditor by allowing it to pursue collection of its loans before the asset is depleted. On the other hand, if the valuation is determined to "adequately protect" the creditor, there is no reason to lift the stay, and the debtor may continue to use the asset(s) in question.

[19] *In re* Savannah Gardens-Oaktree, 146 B.R. 306, 310 (Bankr. S.D. Ga. 1992) (citing Beacon Hill Apartments, Ltd. v. Columbia Sav. & Loan Ass'n (*In re* Beacon Hill Apartments, Ltd.), 118 B.R. 148 (N.D. Ga. 1990)).

### C. *Methods of Valuing Bankruptcy Estates Under Chapter 11 and Chapter 13 Reorganization Claims*

Determination of the liquidation value for an asset or a company is necessary even if the debtor has filed for reorganization under Chapter 11 or Chapter 13, since any reorganization plan proposed by the debtor must provide the secured creditor(s) with an amount that is at least as much as the secured creditor would have received under a Chapter 7 liquidation.[20] This amount may vary, however, depending on the procedure by which the assets are sold. If the assets are sold in an orderly, commercially reasonable manner, in a market that provides exposure sufficient to ensure a competitive bidding process, the proceeds are likely to be higher than if a fire sale liquidation is conducted.

#### 1. Methods of Valuing Collateral in Chapter 13 Individual Debtor Reorganization Plans

Due to the perception that creditors (and the economy overall) fare better when debtors attempt to repay at least part of their debts through reorganization rather than simply selling their assets and turning over the proceeds to their creditors, Congress has provided incentives[20] for debtors to enter the reorganization chapters of the Bankruptcy Code rather than Chapter 7 liquidation. One such incentive is that reorganization plans must provide each secured creditor with an amount that is at least as much as they would have received if the bankruptcy had been commenced under Chapter 7.[21] The importance of this requirement is best understood when one considers that secured creditors can object to the plan put forth by the debtor in Chapter 11 and Chapter 13 reor-

[20] David F. Heroy & Adam R. Schaeffer, *Valuation in Bankruptcy*, 862 PLI-COMM. 153, 166-67 (Apr.-May 2004). "A liquidation analysis is essential in determining whether a plan is confirmable under Bankruptcy Code section 1129(a)(7) . . . ." *Id.* Such a liquidation analysis is also required by the language of Chapter 13, which states that the value of a proposed Chapter 13 reorganization must "not [be] less than the amount that would be paid . . . under [C]hapter 7." 11 U.S.C. § 1325(a)(4) (2000).

[20] Though these incentives are beyond the scope of this Comment, they are worth mentioning here. Under Chapter 13, the debtor may retain the property in question; the debtor may pay the balance of the loan over a period of time, rather than all at once; the debtor has the ability to negotiate more favorable payment terms than those governing the original loan agreement; and debtors facing foreclosure of their homes have the opportunity to reinstate their home loans, even if the creditor has initiated foreclosure proceedings. WARREN & WESTBROOK, *supra* note 12, at 423-25.

[21] *See supra* note 20 and accompanying text.

ganization plans.[22] Both chapters, however, allow the debtor to force the plan on an uncooperative secured party through mechanisms commonly referred to as "cramdown" provisions.[23] To those unfamiliar with the bankruptcy process, these cramdown provisions seem to provide the debtor an unfair advantage over the secured party by giving the debtor the upper hand in deciding how much to pay the secured creditor. Congress protects secured creditors, however, by requiring that reorganization plans filed under Chapter 11 and Chapter 13 provide the secured creditor with an amount equal to the amount the secured creditor would have received under a liquidation plan. For example, cramdowns in Chapter 11 cases are governed by the following provision of the Bankruptcy Code:

> The court shall confirm a plan only if all of the following requirements are met: . . . that each holder of a claim . . . receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the [bankruptcy] estate's interest in such property.[24]

The provision applicable to Chapter 13 cases is very similar:

> Except as provided in subsection (b), the court shall confirm a plan if . . . the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim.[25]

Although the language of the code seems simple, the ambiguity surrounding the proper method for assessing the valuation of a debtor's assets has led to inconsistencies in the application of these provisions.

The valuation of a bankruptcy estate, as seen in the preceding section, rests in large part on the purpose of assessing the valuation. When the valuation is contemplated in the context of a debtor who intends to reorganize rather than liquidate, the valuation often reflects what the market would pay for the debtor's assets as functioning components of the reorganized structure, not the value that the assets would yield in a piecemeal sale.[26] In other

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[22] *See* 11 U.S.C. §§ 1126, 1325 (2000). The creditor typically objects to the debtor's plan on the grounds that the plan impairs the creditor's ability to collect on its original loan.

[23] *See* 11 U.S.C. §§ 1129(b)(2)(A), 1325(a)(5)(B)(ii) (2000).

[24] 11 U.S.C. § 1129(a), (b)(2)(A)(i)(II) (2000).

[25] *Id.* § 1325(a)(5)(B)(ii).

[26] *See In re* Chateaugay Corp., 154 B.R. 29, 34 (Bankr. S.D.N.Y. 1993) (holding that when the debtor intends to continue operating its business after reorganizing

words, in reorganizations, the assets are valued in a manner that captures the cumulative effects of the assets, including the intangible effects that the parts often infuse into the whole, rather than a manner that simply reflects the appropriate value for each asset standing separately.[27]

Although these valuation methods are more obviously relevant to Chapter 11 reorganizations because those claims involve corporations and partnerships rather than individuals, their relevance to Chapter 13 filings is critical as well. Creditors in Chapter 13 receive more than they would in Chapter 7 because the Chapter 13 debtor can continue to use the asset to generate more income whereas the Chapter 7 debtor must sell the asset. In other words, the operating income generated by the asset is worth more to the creditor than the market value of the asset itself. This concept is illustrated in *In re Reynolds*,[28] in which the court found that the debtors' decision to retain their vehicle benefited the creditor by increasing the creditor's claim due to the "going concern value" represented by the debtors' continued use of the vehicle.[29]

a. Replacement Value Method

As the name suggests, the replacement valuation method is calculated by determining what cost the debtor would incur to replace the collateral in question.[30] Proponents of this method rely on the second sentence of section 506(a) of the Code, which states in pertinent part that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."[31] The Supreme Court grappled with the interpretation of this statute in *Associates Commercial Corp. v. Rash*.[32]

The Court in *Rash* defined replacement value as the "price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller."[33] The majority focused on the "proposed disposition or use" language of section

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under Chapter 11, the proper valuation method is the reorganization method rather than a liquidation analysis).

[27] *See, e.g.*, *In re* PWS Holding Corp., 228 F.3d 224, 233 (3d Cir. 2000) (agreeing with the Examiner that the "enterprise evaluation was the appropriate measure of solvency because KKR acquired Bruno's as a going concern").

[28] 17 B.R. 489 (Bankr. N.D. Ga. 1981).

[29] *Id.* at 493.

[30] Chris Lenhart, *Toward a Midpoint Valuation Standard in Cram Down: Ointment for the Rash Decision*, 83 CORNELL L. REV. 1821, 1839 (1998).

[31] 11 U.S.C. § 506(a) (2000); *see also* Lenhart, *supra* note 32, at 1839-40.

[32] 520 U.S. 953 (1997).

[33] *Id.* at 960.

506(a)[34] in support of its holding that the replacement value should be considered from the debtor's point of view, rather than the creditor's.[35] The emphasis on the "proposed disposition or use" viewpoint was also determinative in *In re Trimble*,[36] in which the Eighth Circuit Court of Appeals stated that "where a debtor intends to retain and use the collateral, the purpose of the valuation is to determine the amount an undersecured creditor will be paid for the debtor's continued possession[,] . . . not to determine the amount such creditor would receive if it hypothetically had to repossess and sell the collateral."[37] By analyzing the replacement value from the debtor's point of view, *Rash* equated replacement value with fair market value, as opposed to the foreclosure value that would result if the secured creditor's perspective were adopted.[38] *Rash* further advocated replacement value from the debtor's perspective when it pointed out that the creditor is entitled to neither "the property nor its value" in a Chapter 13 cramdown situation.[39]

In *In re Kim*,[40] the Ninth Circuit Court of Appeals adopted the view that fair market value is the proper valuation method. In that case, the collateral in question was the debtor's dry cleaning equipment. The debtor wished to continue operating his dry cleaning business and attempted to reorganize under Chapter 13 rather than liquidate under Chapter 7.[41] The court of appeals ruled that the proper valuation method was the fair market value of the equipment, not its value at a foreclosure sale.[42] Furthermore, the court in *Kim* held that the equipment should be valued at the fair market value of the equipment in its current location, and not the fair market value the equipment might bring if valued in the context of an off-premise location.[43] Thus, *Kim* not only called for a fair market valuation, but it restricted the definition of "market" to the physical location of the collateral in question.

At the risk of oversimplification, proponents of the replacement value method who advocate adopting the debtor's perspec-

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[34] 11 U.S.C. § 506(a) (2000).

[35] *Rash*, 520 U.S. at 960-65. See Heroy & Schaeffer, *supra* note 20, at 159, for a discussion of the proper "perspective" when considering replacement value.

[36] 50 F.3d 530 (8th Cir. 1995).

[37] *Id.* at 532.

[38] Heroy & Schaeffer, *supra* note 20, at 159-60.

[39] *Rash*, 520 U.S. at 962.

[40] 130 F.3d 863 (9th Cir. 1997).

[41] *Id.* at 864.

[42] *Id.* at 865.

[43] *Id.*

tive urge that because the debtor is proposing to retain the collateral in question in cramdown cases, the correct valuation is simply the amount the debtor would be forced to pay to obtain that specific asset. Proponents of replacement value also use a risk/reward analysis to support the use of this method. The secured creditor's interest in the asset would be negatively impacted if the debtor's reorganization were unsuccessful.[44] The secured creditor is compensated for this risk by capturing any excess that may result from a successful reorganization.[45] Such excess is created when the secured creditor receives more than it would have under either a Chapter 7 liquidation or state law remedies.[46]

The problem with the *Rash* Court's adoption of replacement value is that the Court did not establish how to determine this value. Instead, the Court left it to the bankruptcy courts to decide the "best way of ascertaining replacement value"[47] on a case-by-case basis. Because the *Rash* Court did not clarify the ambiguity of how best to value collateral in Chapter 13 cramdown cases, courts are still free to apply retail value, wholesale value, or some other alternative.[48]

b. Wholesale Valuation Method

Justice Stevens, dissenting in *Rash*,[49] argued that the foreclosure or wholesale valuation is the correct method of valuing collateral in Chapter 13 cramdown cases. He reached his opinion by focusing on the first sentence of section 506(a) instead of the second, leading him to hold that an asset's value should be assessed from the creditor's perspective, not the debtor's.[50] Other proponents of this method rely on statutory interpretation of section 506(a) of the Bankruptcy Code, specifically the phrase "the value of the '*creditor's* interest in the estate's interest' in the property."[51] For example, in *United Savings Association of Texas v. Timbers of Inwood Forest Associates*,[52] the Court held that collateral should be valued "as if it [were] in the creditor's hands."[53] Whereas secured creditors

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[44] Lenhart, *supra* note 32, at 1842.
[45] *Id.*
[46] *Id.*
[47] Assoc. Commercial Corp. v. Rash, 520 U.S. 953, 965 n.6 (1997).
[48] Dawn M. Baumholtz, *Bankruptcy-Debtor's Exercise of the Cram Down Option-Valuation Standard for Collateral in Chapter 13*, 36 DUQ. L. REV. 455, 469-70 (1998).
[49] *Rash*, 520 U.S. at 966.
[50] *Id.* at 966-67.
[51] *Id.* at 966 (quoting 11 U.S.C. § 506(a) (1994)).
[52] 484 U.S. 365 (1988).
[53] Lenhart, *supra* note 32, at 1833.

usually dispose of collateral via the wholesale market, the concepts of foreclosure value and wholesale value are therefore synonymous.[54]

Critics of the wholesale valuation approach argue that the first two sentences of section 506(a) are irreconcilable. Because the debtor in a cramdown case strives to retain the collateral in question, these critics assert that the wholesale valuation method ignores the second sentence of section 506(a), rendering the "disposition or use"[55] language of that section meaningless.

As with other valuation methods, creditors and debtors view the results of the wholesale valuation method from different perspectives, leading each party to favor one method over the other. Debtors believe that by assessing the value of the collateral in the hands of the debtor rather than according to what the debtor would have to pay in the open market to replace the collateral, the wholesale valuation standard embodies the "such creditor's interest in the estate's interest in such property"[56] language referred to previously. The same rationale leads debtors to believe that secured creditors receive an unwarranted windfall when the replacement valuation is used, since the value assigned to the collateral in this method ignores the fact that the debtor already possesses the collateral.[57] In other words, the debtor sees this value as the cost to begin its operations anew rather than the cost to continue operations. The secured creditor, on the other hand, believes that the wholesale valuation method provides a windfall to the unsecured creditors by reallocating the spread between the wholesale and retail (replacement) values to the unsecured class.[58]

c. Midpoint Valuation Method

The aptly named midpoint valuation method is derived simply by calculating the average of the wholesale value described in the previous section and the retail value of the asset in question. This method gained prominence in bankruptcy circles after Judge Posner embraced it in *In re Hoskins*.[59] The property at issue in *Hoskins* was an automobile that the debtor purchased with the proceeds of

[54] *Id.*
[55] 11 U.S.C. § 506(a)(1) (2000).
[56] *Id.*
[57] Lenhart, *supra* note 32, at 1835.
[58] *Id.*
[59] 102 F.3d 311 (7th Cir. 1996), *abrogated by* Assoc. Commercial Corp. v. Rash, 520 U.S. 953 (1997).

a loan obtained from the secured creditor.[60] The bankruptcy court in *Hoskins* distinguished the valuation of real property from that of personal property, holding that real property is more likely to be valued at the retail, or fair market, value, while personal property is more likely to be valued using the wholesale value method.[61]

On appeal to the Seventh Circuit, Judge Posner reasoned that if the court considered the valuation from the debtor's point of view, the correct value of the automobile would be the cost the debtor would incur if he wished to replace the automobile. On the other hand, if the court considered the valuation from the creditor's point of view, the correct value would be the amount the creditor would receive if it sold the automobile in accordance with its normal business practices, i.e., on the wholesale market.[62] Judge Posner referred to this triangular relationship between the debtor, secured creditor, and wholesale or retail market as a "bilateral monopoly"[63] that arrived at the midpoint valuation through a process somewhat akin to a tug-of-war.[64] If the Hoskinses defaulted on their loan, the secured creditor would have repossessed the car and sold it on the wholesale market.[65] On the other hand, in order to replace the car under the replacement value method, the Hoskinses would have been forced to pay the retail price.[66]

Other bankruptcy courts have also held that the midpoint valuation method is preferable because it represents the most equitable approach for all parties involved. The court in *In re Myers*[67] held that the midpoint valuation is a "compromise" that provides "an equitable result."[68] In *In re Stauffer*,[69] the court referred to the midpoint valuation as "the most equitable approach."[70] The court in *In re Younger*[71] held that the midpoint valuation may be valid as a starting point from which valuations may be adjusted either up or down, depending on case specifics.

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[60] *Id.* at 313.
[61] *In re* Hoskins, 183 B.R. 166, 168-69 (Bankr. S.D. Ind. 1995).
[62] *Hoskins*, 102 F.3d at 315.
[63] *Id.*
[64] *Id.* at 315-16.
[65] Lenhart, *supra* note 32, at 1848.
[66] *Id.*
[67] 178 B.R. 518 (Bankr. W.D. Okla. 1995).
[68] *Id.* at 524.
[69] 141 B.R. 612 (Bankr. N.D. Ohio 1992).
[70] *Id.* at 614. See Lenhart, *supra* note 32, at 1849-50, for an excellent discussion of the midpoint valuation method.
[71] 216 B.R. 649, 656-57 (Bankr. W.D. Okla. 1998). See Heroy & Schaeffer, *supra* note 20, at 160-61, for a discussion of the *Younger* holding.

2. Valuing Collateral in Chapter 11 Debtor Reorganization Plans

a. Methods of Chapter 11 Valuations

i. *Comparable Company Analysis*

Another method used to determine the value of a going concern is the comparable company analysis. As the name implies, this technique calls for a comparison of a company's financial condition with that of comparable companies. By comparing the distressed company with companies in better financial condition, courts and practitioners can get an idea of what the distressed company would be worth if its financial structure and operating results improved, which is the goal of any reorganization.[72] Furthermore, the comparable company analysis method allows for the approximation of the value of a going concern without the necessity of actually selling the concern.[73]

Certain disadvantages to this approach, however, are present as well. First, deciding which companies are sufficiently similar to constitute a "comparable" company can be problematic.[74] One method of identifying comparable companies is to identify the main competitors of a particular company. In addition, courts have established the following characteristics that, when considered in the aggregate, may identify comparable companies: (1) products; (2) capital structure; (3) depth of management; (4) personnel experience; (5) nature of competition; (6) earnings; (7) book value; (8) credit status; (9) maturity of business; and (10) markets.[75]

Another potential source of ambiguity when using this valuation method arises when determining which financial indicators should be compared. Among the most widely recognized financial ratios used when conducting comparisons are the price/earnings multiple (PE ratio) and the total enterprise value/EBITDA ratio.[76] The problem with using any financial indicator, however, is that the results are only valid to the extent that the financial ratio represents an accurate portrayal of the healthy company. "For this rea-

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[72] Peter V. Pantaleo & Barry W. Ridings, *Reorganization Value*, 51 BUS. LAW. 419, 421 (Feb. 1996).

[73] Harold S. Novikoff & Beth M. Polebaum, *Valuation Issues in Chapter 11 Cases*, SJ082 ALI-ABA 239, 256-57 (2004).

[74] For an excellent example and analysis of how to select companies that are appropriate for a comparable company analysis, see *In re Pullman Constr. Indus., Inc.*, 107 B.R. 909 (Bankr. N.D. Ill. 1989).

[75] Pantaleo & Ridings, *supra* note 74, at 422-23 (citing Tallichet v. Comm'r, 33 T.C.M. (CCH) 1133 (1974)); Estate of Clarke, 35 T.C.M. (CCH) 1482 (1976)).

[76] Pantaleo & Ridings, *supra* note 74, at 421-22 nn.12-14.

son, it is often useful to analyze a variety of ratios that consider cash flow and other things investors consider important."[77]

ii. *Discounted Cash Flow Model*

One of the more common valuation methods used in valuing bankruptcy estates undergoing reorganization is the discounted cash flow analysis.[78] Several reasons exist for the widespread acceptance of this method. First, it is a forward-looking technique that allows for flexibility in the data used, resulting in an approach that is tailored specifically for the company being analyzed.[79] In addition, because the success of a company's reorganization efforts depends largely on its ability to generate cash flow, the discounted cash flow analysis is perhaps the most relevant method of affixing a value to a company, since the discounted cash flow method measures precisely that characteristic of a company: its ability to generate cash.[80] On more than one occasion, the Supreme Court has equated reorganization value with the value of expected future earnings.[81]

The discounted cash flow analysis estimates the income of an ongoing concern for a certain number of years, then discounts that amount by the proper discount rate, for two reasons: (1) to allow for the fact that the future value of a dollar is less than the value of a dollar today, and (2) to account for the risk that the income estimates might not come to fruition. The resulting value is an approximation of what a concern is worth today as measured in tomorrow's dollars. The first step of the analysis, estimating the future income of a concern, is accomplished in several ways; however, most experts employ either an EBITDA calculation or a net cash flow projection.[82] EBITDA, an acronym that stands for earnings before interest, taxes, depreciation, and amortization, is often divided by the total volume of revenue for a business, a process that yields a ratio known as the EBITDA margin. This margin is then multiplied by the anticipated future annual revenues of a concern in order to arrive at the total value of expected sales for a specific company. Once this value is derived, the applicable interest, tax,

[77] *Id.* at 422.
[78] *Id.* at 427.
[79] *In re* Exide Techs., 303 B.R. 48, 62 (Bankr. Del. 2003).
[80] *Id.*
[81] *See, e.g.*, Consol. Rock Prods. Co. v. DuBois, 312 U.S. 510, 525-26 (1941) (defining reorganization value as "the expectation of income" for the reorganized entity); Protective Comm. v. Anderson, 390 U.S. 414, 442 n.20 (1968) (describing reorganization value as the "present worth of future anticipated earnings").
[82] Steiner Corp. v. Benninghoff, 5 F. Supp. 2d 1117, 1130 (D. Nev. 1998).

depreciation, and amortization charges must be subtracted from the revenue figures in order to arrive at a projected net cash flow. This net cash flow is then discounted by an appropriate interest factor to account for the erosive effect of inflation.

The discounted cash flow analysis, however, presents some problems. The difficulty posed by deciding on an appropriate discount factor acceptable to both the creditor and debtor is one such obstacle. "Typically, the weighted average cost of capital (the WACC) is used to determine the applicable discount rate."[83] The WACC of a company is derived by averaging the costs associated with the use of all sources of capital for that particular company, with each source represented by its "respective percentage share in the capital structure."[84] Notably, however, minor variations in the discount rate often lead to significant differences in the valuation of a concern. This is particularly true in the context of Chapter 11 reorganization proceedings, when the figures involved in the calculations are often quite large.

Another source of conflict in using the discounted cash flow analysis is the determination of the proper length of time over which the cash flow should be measured. Although no standard has emerged from relevant case law, one widely accepted concept is the terminal value. This is the point at which a company stops gaining market share relative to its competitors.[85]

Despite the aforementioned drawbacks inherent in the discounted cash flow approach, one characteristic of this valuation method makes it superior to other valuation methods when valuing a going concern: the discounted cash flow is a forward-looking model, not an historical analysis. The importance of this characteristic is obvious when considered in the context of the situation giving rise to the necessity of valuation. When a company attempts to reorganize, it does so because it realizes its performance has been inferior, but it also believes that operating conditions will improve in the future. Affixing a value to a company based upon the very numbers it is trying to improve penalizes the company for that inferior performance. The use of historical figures also fails to take into consideration the effects that the reorganization efforts may have on the company's valuation.[86]

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[83] Heroy & Schaeffer, *supra* note 20, at 174.
[84] *Id.* at 174-75.
[85] *Id.* at 177.
[86] *In re* Exide Techs., 303 B.R. 48, 62 (Bankr. Del. 2003). Deference to the discounted cash flow analysis was also present in *In re PWS Holding Corp.*, 228 F.3d 224, 233 (3d Cir. 2000), in which an expert appraiser stated that when estimating the value of an ongoing concern, he "favored" the discounted cash flow method

iii. *Price/Earnings Ratio Analysis*

Companies that issue either public or private stock (or ownership units) as a way of establishing owner representation can use a price/earnings valuation method. This involves multiplying the company's average annual earnings for a given period (e.g., the most recent three- to five-year period) by the average P/E ratio for similar companies in order to arrive at an estimate of a company's worth.

Although such a method is appealing in its simplicity, it is inadequate for several reasons. Most importantly, because the earnings of a company facing reorganization have usually been declining for at least the few years immediately preceding its reorganization, a danger exists that the use of a company's recent earnings will lead to an artificially low valuation.[87] Additionally, this model is backward-looking rather than forward-looking, which means that any improvements in the company's performance that may be gained through the reorganization process are completely ignored.[88] Finally, deciding which companies are sufficiently similar to justify use of their P/E multiples may lead to confusion or delays in the bankruptcy litigation, erasing any efficiencies afforded the court by such a plan's simplicity.[89]

b. Importance of Timing When Determining Valuation in Chapter 11 Reorganizations

Another important factor that must be addressed when valuing an asset or business in Chapter 11 proceedings is the timing of the valuation. Although the values of some assets remain stable over time, other assets have values that can change dramatically over time due to depreciation and normal or excessive wear and tear. Additionally, the value of certain assets depends upon prevailing market rates.

It is possible that an asset may be subject to a combination of the forces just described. For example, consider a tractor-trailer at the center of a reorganization claim under Chapter 11. Because Chapter 11 claims often take more than a year to complete, the tractor-trailer may decline in value during the proceedings because

over both the comparable company analysis and the comparable transactions analysis.

[87] JAY ALIX, ROBERT J. ROCK, ET AL., FINANCIAL HANDBOOK FOR BANKRUPTCY PROFESSIONALS: A FINANCIAL AND ACCOUNTING GUIDE FOR BANKRUPTCY JUDGES, ATTORNEYS, AND ACCOUNTANTS §§ 5.21-.25 (2d ed. 2005).

[88] *Id.*

[89] *Id.*

of depreciation, as well as wear and tear, as the debtor continues to use the truck in order to achieve a successful reorganization. Furthermore, if the used tractor-trailer market suffers a decline during the Chapter 11 proceedings, the truck's value declines even further. The problem compounds significantly when the issue of valuation timing is applied to several assets with substantially different characteristics. Although some courts have held that the appropriate timing of a valuation should be decided on a case-by-case basis,[90] most courts determine valuation at either the time the bankruptcy petition is filed or the date the reorganization plan is confirmed.[91]

i. *Valuation at the time the bankruptcy petition is filed*

Courts assigning a valuation upon the commencement of the bankruptcy case do so "because it is on that date that the rights and remedies of the debtor and creditors are created and affected under the provisions of the Bankruptcy Code."[92] The Bankruptcy Court for the Southern District of Georgia followed this approach in *In re Johnson.*[93] Although *Johnson* dealt with a Chapter 13 reorganization as opposed to a Chapter 11 reorganization, the analysis applies to reorganization plans filed under either chapter:

> The petition date best [serves the Bankruptcy Code's objectives] because the filing date commencing the case is the point where the secured creditor's rights were first impacted by the bankruptcy proceeding, and the point where the "tension" between adequate protection . . . and . . . a meaningful chance of rehabilitation to the debtor begins.[94]

Critics of this method argue that assigning a value at this juncture of the bankruptcy claim is inconsistent with section 506(a), which requires that the value of collateral in bankruptcy claims must be determined "in light of the purpose of the valuation."[95] Singling out the petition date as the date of valuation, say these critics, removes the flexibility built into section 506(a), making that section useless. Alternatively, many of these critics assert that valua-

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[90] *See In re* T-H New Orleans Ltd. P'ship, 116 F.3d 790, 798 (5th Cir. 1997) (concluding that courts should be flexible when deciding when to value collateral and should not limit themselves to one date).

[91] *See* Heroy & Schaeffer, *supra* note 20, at 162-65.

[92] Rosemary Williams, Annotation, *Time and Method of Valuation Under 11 U.S.C.A. § 506, of Security Held by Creditor of Bankruptcy Estate* 134 A.L.R. FED. 439, at § 8 (2004).

[93] 165 B.R. 524 (Bankr. S.D. Ga. 1994).

[94] Williams, *supra* note 94, at § 8.

[95] 11 U.S.C. § 506(a) (2000).

tion should occur when the court confirms the reorganization plan.

Proponents of valuation at confirmation argue that the "purpose of the valuation"[96] language of the Bankruptcy Code mandates that collateral be valued at the time a court confirms the reorganization plan. According to these proponents, the debtor's intentions are most clearly stated at the time of confirmation.[97] Determining the value at confirmation is possible even if a valuation has previously been affixed, such as a valuation at the filing of the bankruptcy petition. In cases where a second valuation occurs, at least one court has held that the initial valuation does not override the valuation that occurs at the confirmation stage.[98] Courts that do recognize differences that occur between valuations determined at the filing of the petition and those determined at the confirmation stage are faced with a dilemma: How do the changes in valuation affect the bankruptcy claim?

For example, if the valuation at the confirmation of the plan is greater than the valuation determined at the filing of the petition, should the level of the secured creditor's claim in the collateral be adjusted upwards to reflect the change? In *In re Machinery, Inc.*,[99] the bankruptcy court held that the secured portion of the interest held by the secured creditor does increase when the confirmation valuation is greater than the petition valuation, so long as the secured creditor has a security interest in the proceeds that give rise to the change in valuations.[100]

Situations such as that seen in *In re Machinery* raise another question: May the debtor use proceeds generated during the period between petition and confirmation without affecting the valuation of the secured creditor's claim? The court in *In re Addison Properties, Ltd. P'ship*[101] addressed this issue by implementing a dual valuation system. Under the dual valuation method, the valuation determined at the time the bankruptcy petition is filed is the valuation used to determine the secured creditor's level of adequate protection. The debtor is free to use the proceeds generated during the time period between petition and confirmation, and then

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[96] *Id.*

[97] Crain v. PBS Lending Corp. (*In re* Crain), 243 B.R. 75, 83 (Bankr. C.D. Cal. 1999).

[98] *In re* Ahlers, 794 F.2d 388, 399 (8th Cir. 1986), *rev'd on other grounds sub nom.* Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988); *see also* Heroy & Schaeffer, *supra* note 20, at 164.

[99] 287 B.R. 755 (Bankr. E.D. Mo. 2002).

[100] *Id.* at 762-66.

[101] 185 B.R. 766 (Bankr. N.D. Ill. 1995).

another valuation is carried out at the time of confirmation. Any increase in valuation that occurs, net of the debtor's legitimate use of proceeds, increases the amount of the secured claim.[102]

Of course, this begs the question: What happens when the debtor's use of the collateral and proceeds causes the secured creditor's claim to decrease between the date of petition and the date of confirmation? Such a decrease could change a secured creditor's status from oversecured to undersecured. The court in *In re T-H New Orleans Ltd. Partnership*[103] held that this potential problem was the primary reason why courts should remain flexible when contemplating the appropriate timing of valuation.[104]

## III. DETERMINING THE APPROPRIATE INTEREST RATE TO APPLY IN REORGANIZATION PLANS USING THE CRAMDOWN PROVISIONS

### A. *The Four Different Methods of Determining the Value of a Reorganization Claim Involving the Cramdown Provision of Chapter 13*

*Till v. SCS Credit Corp.*[105] represents the Supreme Court's latest foray into the fog that envelops the numerous methods courts have used when determining the appropriate interest rate to apply in cramdown provisions. In *Till*, Lee and Amy Till bought a used truck for $6,725.75.[106] After taking into consideration the Tills' down payment of $300 and the assessment of interest at 21% per annum for 136 weeks,[107] the initial indebtedness totaled $8,285.24.[108] Approximately one year later, the Tills defaulted on the loan and filed for reorganization under chapter 13 of the Bankruptcy Code.[109] "At the time of the filing, respondent's outstanding claim amounted to $4,894.89, but the parties agreed that the truck securing the claim was worth only $4,000."[110]

By the time *Till* reached the Supreme Court, the four lower courts that heard the case had each identified what it believed to be the appropriate method for determining the rate of interest to be applied in cramdown cases. Those methods are briefly addressed below.

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[102] Heroy & Schaeffer, *supra* note 20, at 165.
[103] 116 F.3d 790 (5th Cir. 1997).
[104] *Id.* at 798.
[105] 541 U.S. 465 (2004).
[106] *Id.* at 469.
[107] *Id.* at 470.
[108] *Id.*
[109] *Id.*
[110] *Id.*

1. Formula Approach

The Tills' reorganization plan "provided that petitioners would pay interest on the secured portion of respondent's claim at a rate of 9.5% per year."[111] The court reached this rate by "augmenting the national prime rate of approximately 8% . . . to account for the risk of nonpayment posed by borrowers in [the Tills'] financial position."[112] The creditor objected on the grounds that if the creditor foreclosed on the loan and reinvested their capital in a new loan, they would obtain 21% (the rate at which sub-prime loans were being made at that time).[113]

This is the point at which most courts (and current bankruptcy literature) seem to get off-track. The Chapter 13 cramdown provision only provides that the secured creditor must receive an amount that "is not less than the *allowed amount of such claim*."[114] Therefore, the key to determining the correct interest rate to apply in such cases (and therefore the valuation that should attach to the asset or estate in question) is to determine whether the "allowed amount of such claim"[115] must include the original interest rate agreed to by the parties (in this case 21%). In other words, using the asset at the center of *Till* as an example, is the "allowed amount of such claim" the value of the truck or the value of the loan? I submit that the correct interpretation is that the "allowed amount of such claim" should be calculated by considering what the asset is worth, because that amount is what is "allowed" under section 506(a). In other words, once the bankruptcy claim is bifurcated into secured and unsecured portions pursuant to section 506(a), the debtor's reorganization proposal need only provide the secured creditor with an amount that is at least equal to the amount considered "secured" by the bankruptcy court.[116]

2. Coerced Loan Approach

As of 2003, the coerced loan approach constituted the prevailing method of calculating cramdown interest rates in the Third,

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[111] *Id.* at 471.
[112] *Id.*
[113] *Id.*
[114] 11 U.S.C. § 1325(a)(5)(B)(ii) (2000) (emphasis added).
[115] *Id.*
[116] The Court in *Till* interpreted this provision the same way, leading the Court to conclude that the Tills' proposed plan had to provide the secured creditor with at least $4,000. *Till*, 541 U.S. at 474.

Fourth, Fifth, Sixth, Seventh, and Eleventh Circuits.[117] The district court in *Till* interpreted Seventh Circuit precedent as mandating that the appropriate level of interest should be "the level the creditor could have obtained if it had foreclosed on the loan, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk,"[118] which in this case was 21%.

The coerced loan approach holds that the appropriate interest rate is one that would compensate the secured creditor for its opportunity cost,[119] or the value of the "lost opportunities for relevant investments the creditor could have made."[120] *Till* correctly dismissed the coerced loan method by holding that this approach "improperly focuses on the creditor's potential use of the proceeds of a foreclosure sale."[121] The Bankruptcy Code does not call for such a narrow application, but instead focuses on the value of the secured party's interest in a specific bankruptcy estate. The fact that the secured creditor could execute new loans to different debtors is irrelevant at this point. The creditor has already made the decision to enter into this specific lending relationship; the only question is how best to value this particular estate. Examining the potential for other lending relationships, as the coerced loan does, is beyond the requirements of the Bankruptcy Code.

3. Presumptive Contract Rate Approach

On appeal in *Till*, the Seventh Circuit began its analysis by agreeing with the district court's focus on the rate the creditor could receive if the current loan were foreclosed and the proceeds reinvested.[122] However, rather than applying that rate, the Seventh Circuit held that the rate was a starting point that should "'serve as a presumptive [cramdown] rate,' which either the creditor or the debtor could challenge with evidence that a higher or lower rate should apply."[123]

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[117] Patrick Halligan, *Cramdown Interest, Contract Damages, and Classical Economic Theory*, 11 AM. BANKR. INST. L. REV. 131, 135 (Spring 2003).
[118] *Till*, 541 U.S. at 472.
[119] Halligan, *supra* note 121 at 135-36.
[120] *Id.* at 134.
[121] *Till*, 541 U.S. at 477.
[122] *Id.* at 473
[123] *Id.* (citing *In re* Till, 301 F.3d 583, 592 (7th Cir. 2002)). According to the Seventh Circuit, the value of the claim in bankruptcy is not precisely the same as that of the asset before the default, because loans to debtors who have had reorganization plans affirmed by the bankruptcy court "involve [not only] some risks that would not be incurred in a new loan to a debtor not in default" but also include "some economies." *In re Till*, 301 F.3d at 592.

4. Cost of Funds Approach

Judge Rovner's dissent from the Seventh Circuit's majority opinion argued that the correct method of valuing the bankruptcy claim should either be the bankruptcy court's formula approach or a fourth approach which he called the "cost of funds" approach.[124] Under this approach, courts simply ask "what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source."[125]

*B. The Impact of the Till Court's Failure to Establish a Method of Determining the Risk Premium Inherent in the Formula Approach*

The Supreme Court in *Till* adopted the formula approach as the correct method of valuing bankruptcy claims, under the theory that the other three approaches sought to "make each individual creditor whole rather than to ensure that [the] debtor's payments have the required present value."[126] However, the Court did not provide any guidance as to how the formula approach should be implemented; instead, it announced that "the proper scale for the risk adjustment," which is a critical component of the formula, was "not before us."[126] The scope and applicability of *Till* is therefore limited, in that bankruptcy courts are still left in the dark as to how to properly ascertain the value of a bankruptcy estate, especially one that encompasses a debtor exercising his privilege to invoke the cramdown provision.

Rather than attempting to decide the "proper scale for the risk adjustment," the correct inquiry at this point should instead focus on whether the formula approach that the Court embraced in *Till* is the best alternative. It is not. Rather, the Court, as many courts

[124] *Till*, 541 U.S. at 473.

[125] *In re Till*, 301 F.3d at 595. Judge Rovner argued that creditors include in their original interest rate an amount of interest designed to compensate them for the possibility that the debtor might default, and that allowing creditors to recalculate a rate that includes such a default possibility a second time may result in "overcompensate[ing]" creditors. *Till*, 541 U.S. at 473.

[126] *Till*, 541 U.S. at 477. The Court addressed the fact that the three approaches it rejected (the coerced loan approach, the presumptive contract approach, and the cost of funds approach) all erroneously focused on the creditor. Specifically, the coerced loan and presumptive contract approaches both focused on the opportunity cost imposed on the creditor by calculating what rate the creditor *could* have received in another relationship rather than concentrating on the existing relationship. The cost of funds approach mistakenly focused on the creditor's creditworthiness rather than that of the debtor. *Id.* at 477-79.

[126] *Id.* at 480. The Court held that its obligation was simply to "select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan." *Id.*

before it, lost sight of the actual requirement of section 506(a). According to the language of that section, a court need not allow augmentations to an interest rate in order to account for the risk that the debtor might re-default on his commitments to the secured creditor. Furthermore, a court need not concern itself with what rate a creditor may receive if it attempted to replace the defaulting debtor with another debtor. Section 506(a) does not mandate that the creditor receive at least what it would receive if it took its business elsewhere; it focuses instead on the relationship at hand.

The proper method, therefore, when deciding the appropriate interest rate to apply in cramdown situations should be simply to equate the present value of the anticipated future payments made by the debtor under his reorganization plan, as approved by the court or trustee, with the present value of the claim. The discounted cash flow, discussed earlier as a method of calculating the value of a going concern, provides the calculations necessary to accomplish this goal, and should therefore be the tool by which courts determine the valuation of a bankruptcy estate and measure the requirements of section 506(a). Instead of augmenting the prime rate with an arbitrary interest rate, as adopted in *Till*, the prime rate should simply be augmented by the rate of inflation. This rate can then be entered into a discounted cash flow analysis to determine the appropriate payments due the secured creditor.

Consider the following point. If a debtor proposes a reorganization under Chapter 13 and pays the value of the claim up front, she would satisfy the requirements imposed by section 506(a). The debtor, by satisfying the claim over time rather than up front, is adding only one factor to the mix: time. Therefore, the only calculation necessitated by cramdown provisions paid over time is one designed to equate the total value of a stream of future payments with the present value of those payments. To do this, the calculation needs to stem the erosive effect that the passage of time inflicts upon the value of a dollar. This erosive effect is calculated simply by ascertaining the rate of inflation. According to the United States Federal Reserve, the Consumer Price Index (CPI) is one measure of inflation.[127] Once the court determines the rate at which the value of a dollar is decreasing, it can combine this figure with the prime rate of inflation, yielding a hybrid interest rate that

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[127] The Federal Reserve Board, Frequently Asked Questions, http://www.federalreserve.gov/generalinfo/ faq/faqei.htm#1 (last visited Jan. 14, 2005). "The CPI measures inflation as experienced by consumers in their day-to-day living expenses . . . ." *Id.*

is then inserted into the discounted cash flow analysis. This yields the amount a debtor must pay on a monthly basis for a period of three to five years[128] in order to provide the creditor with a payout equal to what the creditor would receive if paid in full today.

The discounted cash flow method is an approach that even judges who are not comfortable with financial formulas could use with ease. One can perform the analysis quickly and accurately using a simple spreadsheet-based program. A judge need not be familiar with the intricacies of the analysis; she would simply insert the value of the claim and the appropriate discount rate, which would be the rate at which the value of the dollar is falling at the time a particular valuation is being conducted. Because the CPI is a number used by economists worldwide as a representation of inflation, and because this figure can be easily determined and uniformly applied across all jurisdictions,[129] the uncertainties faced by the Supreme Court in *Till* can be resolved.

## IV. CONCLUSION

Courts have unnecessarily confused the subject of proper bankruptcy estate valuations by ignoring the plain language of the Bankruptcy Code. By focusing on section 506(a), courts can correctly establish the proper method by which to assess bankruptcy valuations. One factor complicating courts' efforts to determine the valuation of collateral in bankruptcy claims is the existence of numerous methods by which to determine these valuations. Because the assets involved in a bankruptcy claim, whether the claim is filed by an individual or a business, could constitute any form of asset imaginable, it is irrational to attempt to apply the same valuation method in each and every bankruptcy case. However, a close reading of section 506(a) of the Bankruptcy Code can provide the answer to the question of which method to use in each case.

When the valuation of collateral takes place in the context of a Chapter 7 liquidation, section 506(a) implies that the appropriate method of valuation is the wholesale liquidation method, because the creditor will often repossess the collateral and sell it, typically on a wholesale market. Thus, the valuation is conducted "in light of the purpose of the . . . proposed disposition or use of such property."[130] On the other hand, when the valuation occurs in a Chapter

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[128] 11 U.S.C. § 1322(d) (2000).

[129] The CPI is published in numerous financial publications such as the *Wall Street Journal* and *Barrons*.

[130] 11 U.S.C. § 506(a)(1) (2000).

13 reorganization, the valuation method that best reflects the spirit of section 506(a) is the replacement value, because the proposed use of the collateral is the debtor's retention of the collateral. If the debtor were to acquire the collateral outside the context of bankruptcy, the replacement value best approximates the amount the debtor would pay, and is therefore an appropriate value for a bankruptcy proceeding.

For collateral in Chapter 11 reorganizations, which typically involve business debtors attempting to retain collateral so they may continue operating their businesses, the discounted cash flow analysis is the most appropriate manner of determining value within the requirements of section 506(a). In a business context, the value of an asset on any given day is best represented by that asset's ability to generate income in the foreseeable future. However, rather than merely attempting to forecast the amount of income an asset might or might not produce in the future, the discounted cash flow analysis allows a more accurate valuation of an asset due to the method's ability to account for the risks inherent in any forward-looking model: the risk that the income might not be realized and the risk (or cost) imposed by time's erosive effect of monetary inflation.

In addition, courts can resolve the circuit split that currently plagues bankruptcy cases involving cramdown provisions by establishing the proper interest rate calculations to apply in Chapter 11 and Chapter 13 cases. By combining the prime rate with the rate of inflation, a court can determine the appropriate rate of interest to apply to reorganization plans proposed in cramdown cases.

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