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## Tilling the Cram Down Landscape: Using Securitization Data to Expose the Fundamental Fallacies of "Till"

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# ***Tilling the Cram Down Landscape: Using Securitization Data to Expose the Fundamental Fallacies of Till***

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## I. INTRODUCTION

It is almost universally recognized that the Bankruptcy Code's protection for consumers is justifiable under the theory that an "entrepreneurial economy prospers when honest but unfortunate

debtors are given a fresh opportunity to swim back into the productive mainstream rather than being forced down to drown.”<sup>1</sup> The amount of protection the Bankruptcy Code (hereinafter, the “Code”) should afford consumers, on the other hand, is a source of much disagreement. Long-standing debate over this issue was, in fact, the basis for the controversy surrounding the Bankruptcy Abuse Prevention and Consumer Protection Act (“the Act”) that the President signed into law in April of 2005. The Act makes “the most substantial changes to the Bankruptcy Code since its enactment in 1978,”<sup>2</sup> and appears to be a major victory for those who believe consumer abuse had overwhelmed the bankruptcy process and that reform was necessary in order to “heighten the integrity of the system and to increase the accountability of debtors, creditors and their counsel.”<sup>3</sup>

In the midst of all of the attention over the Act, however, commentators and politicians have in large part overlooked what the Act did not change. Most importantly, the Act failed to address several vital controversies surrounding Chapter 13, and these oversights will continue to present major hurdles to bankruptcy practitioners,<sup>4</sup> petitioners, and secured creditors in the coming years. To further complicate matters, the Act severely limits the availability of Chapter 7 to consumers, which will greatly increase the usage of Chapter 13 and therefore compound the negative impact of congressional inaction regarding these Chapter 13 ambiguities.

The Chapter 13 process itself, however, will largely operate as it did under previous bankruptcy law. It will continue to permit the debtor to retain assets even if they are pledged as collateral, and as long as the debtor can provide the corresponding secured creditor with the equivalent of its allowed secured claim, the creditor’s consent

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1. *Bankruptcy Abuse Prevention and Consumer Protection Act of 2001: Hearing on H.R. 333 Before the H. Comm. on the Judiciary*, 107th Cong. 183 (2001) (statement of Ralph R. Mabey), available at <http://judiciary.house.gov/media/pdfs/printers/107th/71179.pdf>; see *Kelly v. Robinson*, 479 U.S. 36, 46 (1986) (stating that the bankruptcy process is “intended to relieve an honest and unfortunate debtor of his debts and to permit him to begin his financial life anew” (quoting *State v. Mosesson*, 356 N.Y.S.2d 483, 484 (1974) (citations omitted in original))).

2. HON. WILLIAM HOUSTON BROWN & LAWRENCE AHERN III, 2005 BANKRUPTCY REFORM LEGISLATION WITH ANALYSIS 1 (2005).

3. Clifford J. White III, *Bankruptcy Reform Implementation Now Underway at the USTP*, AM. BANKR. INST. J., June 2005, at 14, 14.

4. See John Caher, *New Law Raises Stakes for Debtors’ Attorneys*, N.Y.L.J., Oct. 14, 2005, at 1, 1, available at <http://www.law.com/jsp/article.jsp?id=1129280709784> (“Suddenly, attorneys will be personally liable for the accuracy of their clients’ petitions. They will be required to advertise themselves as ‘debt relief agencies.’ They will be barred from telling clients certain pertinent information, such as the fact that it is legal to incur new debt on the eve of bankruptcy. And they will be required to give advice that some practitioners say is directly contrary to other sections of the U.S. Bankruptcy Code, potentially pitting their ethical obligations against their legal responsibilities.”).

remains unnecessary.<sup>5</sup> For obvious reasons, the majority of Chapter 13 debtors do not have the cash available at the time of their bankruptcy to pay off their secured creditors' claims in one lump sum, so their plans typically propose repayment in the form of a three- to five-year payment plan.<sup>6</sup> Furthermore, in recognition of basic financial principles such as the time value of money and the default risk involved in a promise of future payments, the amended Code continues to require that the amount of each proposed payment be calibrated so that the creditor will receive disbursements with a present value equal to that of its secured claim at the time of the petition.<sup>7</sup> This present value calibration will continue to be effectuated using a discount rate<sup>8</sup> proposed by the debtor, which the court must approve in order to confirm the plan.<sup>9</sup>

The Code itself has never specified how the discount rate should be calculated,<sup>10</sup> and the Act failed to resolve or even address this highly controversial issue. As a result of this spoiled congressional opportunity, this crucial concept remains a matter of case law. Of course, despite Congress's inaction, one would expect that the sheer number of Chapter 13 cases that arise on a yearly basis<sup>11</sup> would have required that courts establish a uniform method for calculating this rate long ago. However, in the pre-Act case of *Till v. SCS Credit Corp.*, the Supreme Court acknowledged that various lower courts were using four distinct methods of conducting the Chapter 13 present value analysis<sup>12</sup> and ostensibly granted certiorari

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5. See 11 U.S.C. § 1325(a)(5)(B) (2006) (listing the requirements for confirmation of what is known as a "cram down" plan).

6. See *Till v. SCS Credit Corp.*, 541 U.S. 465, 469 (2004) (Stevens, J., concurring) ("Plans that invoke the cramdown power often provide for installment payments over a period of years rather than a single payment.").

7. *Id.* (stating that "each installment [payment] must be calibrated to ensure that . . . the creditor receives disbursements whose total present value equals or exceeds that of the allowed claim").

8. While there are some conceptual differences between the two terms, "interest rate" and "discount rate" are used interchangeably throughout this Note.

9. See *Till*, 541 U.S. at 472 n.8 (noting that the court's review of the discount rate is part of its determination of whether the plan is financially feasible).

10. See *id.* at 473 ("The Bankruptcy Code provides little guidance as to which of the rates of interest advocated by the four opinions in this case—the formula rate, the coerced loan rate, the presumptive contract rate, or the cost of funds rate—Congress had in mind when it adopted the cramdown provision.").

11. See Press Release, Admin. Office of the U.S. Courts, Number of Bankruptcy Cases Filed in Federal Courts Up Less Than One Percent for 12-Month Period, Quarterly Filings up 11 Percent (Aug. 24, 2005), available at [http://www.uscourts.gov/Press\\_Releases/bankruptcyfilings82405.html](http://www.uscourts.gov/Press_Releases/bankruptcyfilings82405.html) (noting that there were over 440,000 Chapter 13 filings in the 2005 fiscal year alone).

12. See *Till*, 541 U.S. at 469 (noting that "the Bankruptcy Judge, the District Court, the Court of Appeals majority, and the dissenting Judge each endorsed a different approach").

to clear up this lack of uniformity.<sup>13</sup> In light of the multitude of times this issue arose in lower courts and the rarity of the Supreme Court's intrusions into consumer bankruptcy issues,<sup>14</sup> it would appear at first glance that the Tills won the legal lottery when the Court decided to hear their appeal from a Seventh Circuit decision. However, even a cursory review of the proceedings makes it clear that the Tills' case was the epitome of legal uncertainty and apparent arbitrariness, and provided the Court with an especially compelling call to action.

The Tills' bankruptcy adventure began when they used what is known as the "formula" or "prime-plus" approach to calculate the cram down rate<sup>15</sup> for their bankruptcy plan.<sup>16</sup> This approach generated a discount rate of 9.5%, which the bankruptcy court confirmed.<sup>17</sup> The district court, however, reversed by adopting the "coerced loan approach," which yielded a cram down rate of 21%.<sup>18</sup> On appeal from the district court's decision, the Seventh Circuit employed the "presumptive contract rate approach."<sup>19</sup> While conceptually distinct from the method used by the district court, this court also held that a 21% rate was appropriate.<sup>20</sup> Finally, the dissent in the Seventh Circuit argued for the adoption of a fourth method known as the "cost of funds approach"<sup>21</sup> which would have generated a discount rate in the neighborhood of the 9.5% rate the Tills had proposed.<sup>22</sup>

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13. See *id.* ("The proceedings in this case that led to our grant of certiorari identified four different methods of determining the appropriate method with which to perform [the present value calculation]."); Thomas J. Yerbich, *How Do You Count the Votes—Or Did Till Tilt the Game?*, AM. BANKR. INST. J., Aug. 2004, at 10, 10 ("The Supreme Court granted certiorari to resolve a conflict among the circuits.").

14. See Henry E. Hildebrand, *TILL: Prime Plus*, NORTON BANKR. L. ADVISER, July 2004, at 8, 8 ("Rarely does the Supreme Court consider cases which immediately impact everyday bankruptcy practice. Rarer still does the Court take up bankruptcy issues that directly involve consumer practitioners.").

15. The term "cram down rate" refers to the rate of interest that will be used to calibrate the stream of payments that an objecting secured creditor will receive "to ensure that, over time, the creditor receives disbursements whose total present value equals or exceeds that of the allowed claim." *Till*, 541 U.S. at 469.

16. *Id.* at 471.

17. *Id.* at 471–72.

18. *Id.* at 472.

19. *Id.* at 472–73.

20. *Id.*

21. *Id.* at 473.

22. "Strictly speaking, the debtor's retention of the collateral does not preclude the creditor from making a new loan, it simply deprives the creditor of an asset that the creditor could convert into money and use to fund the new loan. A straightforward way to account for that deprivation is to ask what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source." *In re Till*, 301 F.3d 583, 595 (7th Cir. 2002) (Rovner, J., dissenting).

By the time the Tills' case reached the Supreme Court, the Justices had a "virtual smorgasbord of options from which to choose."<sup>23</sup> To the dismay of secured creditors everywhere,<sup>24</sup> the opinion written by Justice Stevens, which became that of the plurality, adopted the formula method.<sup>25</sup> The four-Justice dissenting opinion authored by Justice Scalia, on the other hand, endorsed the presumptive contract rate approach.<sup>26</sup> Complicating matters significantly, Justice Thomas concurred in the judgment of the plurality but seriously called into question the usefulness of the *Till* opinion by arguing that secured creditors are entitled to nothing more than the risk-free rate of interest, thereby creating a *fifth* method of calculating cram down rates.<sup>27</sup> The problem for lower courts applying *Till* is that Justice Thomas simply concurred with the method that in the Tills' situation yielded the cram down rate closest to the risk-free rate of interest.<sup>28</sup> As a result, since there are conceivable situations where the formula approach would yield a rate higher than the presumptive contract rate approach,<sup>29</sup> it appears that if this issue reached the Supreme Court again, the dissent and plurality might swap roles.<sup>30</sup> Additionally, the recent changes in the composition of the Court only add to the uncertainty surrounding the stability of the *Till* decision.<sup>31</sup>

In the minds of many, the Court's four-four-one decision in *Till* squandered a "marvelous opportunity to impose some much-needed order and predictability" as to which of the approaches for calculating

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23. Yerbicb, *supra* note 13, at 10.

24. See Clyde Mitchell, *High Court Takes Interest in 'Cramming Down' Banks*, N.Y.L.J., July 14, 2004, at 3, 3, available at <http://www.whitecase.com/publications/detail.aspx?id=880d930b-58b6-46f3-93c3-1914f4427e47> (explaining that *Till* "has far reaching implications for banks acting as secured lenders in cases arising under the 'cramdown' provisions of the Bankruptcy Code"); Dennis J. Connolly, *High Court Cram-Down Decision Will Have Big Impact*, NAT'L L.J., Aug. 9, 2004, at 20, 20 (predicting that the "4-1-4 plurality decision" will have "far-reaching economic consequences for subprime lenders and secured creditors generally").

25. See *Till v. SCS Credit Corp.*, 541 U.S. 465, 479-80 (2004) (Stevens, J., plurality opinion) ("[T]he prime-plus or formula rate best comports with the purposes of the Bankruptcy Code.").

26. *Id.* at 491-92 (Scalia, J., dissenting).

27. *Id.* at 488 (Thomas, J., concurring).

28. *Id.* at 491.

29. For example, if the debtor at the time of the loan was a low enough credit risk to receive an incentive interest rate on her car loan that was below the prime rate of interest, the plurality's method would actually result in a higher rate.

30. See *Till*, 541 U.S. at 491 (Thomas, J., concurring) (arguing that because "the 9.5% rate is higher than the risk-free rate" it sufficiently compensates creditors; therefore, the judgment of the court of appeals which resulted in a 21% rate was misguided and should be overturned).

31. Since their predecessors sided with Justice Scalia, the appointments of Chief Justice Roberts and Justice Alito will probably not change the votes on the *Till* issue if it reaches the Court again. Nevertheless, predictions as to the likelihood that either of the new Justices would side with Justice Stevens would be extremely speculative at this point and are outside the scope of this Note.

the discount rate should be used in the Chapter 13 context.<sup>32</sup> However, in contrast to the bulk of commentary concerning this issue, this Note does not argue *Till*'s primary flaw was that none of the aforementioned methods gained the support of a majority of Justices. Instead, this Note asserts that the fundamental mistake in *Till* was that the Court deliberated over which of these methods should be adopted rather than acknowledging that they all fail to comply with the Code. This Note argues that the inadequacies of the existing methods result from their attempt to predict the answer to an inherently mathematical question (the present value of a stream of future payments) without engaging in any sort of quantitative analysis. As a result, the methods amount to nothing more than educated guesses and differ only by their starting points rather than their methodology. This Note's ambition is to at least reframe the issue so that it might eventually be resolved using objective data.

Part II of this Note provides a context for the *Till* issue by briefly outlining the facts of the *Till* case itself and explaining what, if anything, the *Till* opinion actually resolved. Part III discusses the two approaches that appear to be viable post-*Till*, and explains the flaws that prevented them from gaining the support of more than four Justices. In a break from the previous commentary on this issue, Part IV presents data garnered from consumer automobile loan securitizations in an attempt to quantitatively compare loans made outside of bankruptcy to the *de facto* loans created by Chapter 13 cram down plans. Finally, Part V uses the comparisons discussed in Part IV in an attempt to predict what the financial markets would consider to be appropriate risk premiums for cram down plans, and goes on to suggest ways in which the *Till* issue could ultimately be resolved. Part VI concludes.

## II. THE *TILL* PROBLEM

### A. *The Tills' Experience with Chapter 13*

In October of 1998, Lee and Amy Till purchased a used truck for \$6,725.75 from Instant Auto Finance.<sup>33</sup> The purchase was financed with a \$300 down payment and a retail installment contract which was eventually assigned to SCS Credit Corporation ("SCS").<sup>34</sup>

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32. Ralph Brubaker, *Cramdown Interest Rates: Disarray Dominates Till . . . ?*, BANKR. L. LETTER, Aug. 2004, at 1, 1.

33. *Till*, 541 U.S. at 469.

34. *Id.* at 470.

The terms of the financing included a 21% finance charge per year for 136 weeks, which amounted to a finance charge over the term of the loan of \$1,859.49.<sup>35</sup> The contract also provided that Instant Auto Finance retained a purchase money security interest which was subsequently assigned to SCS. This security interest gave the lender the right to repossess the truck if the Tills defaulted.<sup>36</sup>

Approximately one year after the purchase of the truck the Tills ended up defaulting on their payments to SCS and filing a joint petition for relief under Chapter 13 of the Bankruptcy Code.<sup>37</sup> By the time the petition was filed the loan balance had been paid down to about \$4,900; however, both SCS and the Tills agreed that the truck was only worth approximately \$4,000.<sup>38</sup> As a consequence, SCS's secured claim was limited to \$4,000 and the balance became an unsecured claim.<sup>39</sup>

The Tills' Chapter 13 plan was designed to last for three years and provided that they would submit \$740 of their wages to the trustee each month.<sup>40</sup> As to SCS's claim, the plan provided that the Tills would keep the truck by retaining SCS's lien and promising a sufficient portion of the monthly payments to SCS. In an attempt to compensate SCS for the fact that the promise of future payments was worth less than a lump-sum payoff would have been, the plan provided that the payments would incorporate a 9.5% interest rate.<sup>41</sup> To arrive at this rate, the Tills started with the national prime rate of interest and added a small risk premium to account for the additional default risk that borrowers in the Tills' financial position typically pose.<sup>42</sup> SCS objected to this calculation and asserted that the appropriate interest rate for calibrating the installment payments under the bankruptcy plan was the contractual rate that the truck had originally been subject to, which in this case was 21%.<sup>43</sup>

The bankruptcy court held a hearing on SCS's objection and eventually found that the formula approach used by the Tills was

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35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*; see 11 U.S.C. § 506(a)(1) (2006) ("An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.").

40. *Till*, 541 U.S. at 471.

41. *Id.*

42. *Id.*

43. *Id.*



appropriate.<sup>44</sup> SCS appealed that decision to the federal district court, which reversed, reasoning that the interest rate in this context should be equal to “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.”<sup>45</sup> As a result of this line of thinking, the district court held that the 21% rate from the original contract was appropriate.<sup>46</sup>

The Tills appealed the district court decision to the Seventh Circuit Court of Appeals, which endorsed a third way of calculating the discount rate in this context.<sup>47</sup> The majority held that the interest rate agreed to in the original contract should serve as the presumptively correct discount rate, but that either party could rebut that presumption with evidence that a different rate would be more appropriate.<sup>48</sup> The court then remanded the case to the bankruptcy court to determine whether either party could rebut the presumption that the 21% rate should be applied.<sup>49</sup> The Seventh Circuit dissent proposed a fourth method of calculating discount rates, under which the present value calibration would use the rate that it would “cost the creditor to obtain the cash equivalent of the collateral from an alternative source.”<sup>50</sup>

### *B. Did Till Accomplish Anything?*

The Tills appealed the Seventh Circuit’s decision to the United States Supreme Court, which granted certiorari to resolve the split of opinion in lower courts as to which of the four methods of calculating cram down rates was most appropriate. Most legal observers expected that the Court would end the controversy by endorsing one of those methods. The Court, however, did not meet these expectations and did little to resolve the confusion.<sup>51</sup>

In the *Till* decision, Justice Stevens wrote an opinion adopting the formula method; he was joined by Justice Souter, Justice

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44. *Id.* at 472.

45. *Id.*

46. *Id.*

47. *Id.* at 472–73.

48. *Id.* at 473.

49. *Id.*

50. *In re Till*, 301 F.3d 583, 595 (7th Cir. 2002) (Rovner, J., dissenting).

51. See Brubaker, *supra* note 32, at 1 (noting that the Supreme Court had “a marvelous opportunity to impose some much-needed order and predictability” and that instead of conclusively endorsing one of the existing approaches, the Court provided little “to guide and constrain the lower courts, aside from pre-*Till* circuit precedent not inconsistent with *Till*”).

Ginsburg, and Justice Breyer.<sup>52</sup> This opinion became that of the plurality because Justice Thomas wrote a separate opinion concurring in the judgment of the Stevens group.<sup>53</sup> His opinion, however, endorsed a fifth method for calculating the discount rate; he asserted that all of the other methods overcompensated creditors because 11 U.S.C. § 1325(a)(5)(B)(ii) does not require that the proper discount rate in a cram down plan reflect the risk of nonpayment.<sup>54</sup> Finally, Justice Scalia wrote a dissenting opinion which was joined by the remaining three Justices, and asserted that the presumptive contract rate approach that had been applied by the Seventh Circuit was the proper method as it actually compensated creditors for the risk that they were being subjected to in Chapter 13 plans.<sup>55</sup>

Although the *Till* decision did not clear up the confusion surrounding the calculation of discount rates as much as many had hoped it would, it does seem to eliminate several of the previously used techniques as viable options. The first method rejected by the Court was the risk-free rate approach proposed by Justice Thomas in his concurrence.<sup>56</sup> Justice Thomas essentially argued that 11 U.S.C. § 1325(a)(5)(B)(ii) does not require the courts to consider anything other than the risk-free rate of interest:

I agree that a “promise of future payments is worth less than an immediate payment” of the same amount, in part because of the risk of nonpayment. But this fact is irrelevant. The statute does not require that the value of the promise to distribute property under the plan be no less than the allowed amount of the secured creditor’s claim. It requires only that “the value . . . of property to be distributed under the plan,” at the time of the effective date of the plan, be no less than the amount of the secured creditor’s claim. 11 U.S.C. § 1325(a)(5)(B)(ii). Both the plurality and the dissent ignore the clear text of the statute in an apparent rush to ensure that secured creditors are not undercompensated in bankruptcy proceedings. But the statute that Congress enacted does not require a debtor-specific risk adjustment that would put secured creditors in the same position as if they had made another loan.<sup>57</sup>

While Thomas’s distinction between the value of the promise to distribute property and the value of the property itself could generate interesting debate, this Note will not spend significant amounts of time discussing it because, as Justice Thomas concedes, “[b]oth the plurality and the dissent agree that ‘[a] debtor’s promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away,

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52. *Till*, 541 U.S. at 467, 479–80.

53. *Id.* at 467.

54. *Id.* at 485–87, 491.

55. *Id.* at 491–92.

56. *See id.* at 508 (Scalia, J., dissenting) (“Eight Justices are in agreement that the rate of interest set forth in the debtor’s approved plan must include a premium for risk.”).

57. *Id.* at 485–86 (Thomas, J., concurring).

inflation may cause the value of the dollar to decline before the debtor pays, and there is always some *risk of nonpayment*.”<sup>58</sup> As a result, the Supreme Court aligned eight to one in favor interpreting the cram down provisions as requiring more than just the risk-free rate of interest.<sup>59</sup>

The second method eliminated by the Court was the cost of funds approach adopted by the dissent in the Seventh Circuit opinion.<sup>60</sup> The biggest hurdle to the effectiveness of the cost of funds approach is that this method is difficult to apply, as it would require bankruptcy courts to conduct evidentiary hearings to determine the lender’s cost of capital.<sup>61</sup> In addition, it seems to disregard the fact that creditors do not have an unlimited borrowing capacity, so the cost to the creditor of borrowing the equivalent value of the collateral will almost always be more than just the simple interest rate they would be charged.<sup>62</sup> Finally, this approach does not seem to be consistent with the Code itself as it focuses on the creditor<sup>63</sup> and completely ignores the risk that the debtor could default on the interest payments.

The final technique rejected by a majority of the Justices in *Till* is the coerced loan approach.<sup>64</sup> In rejecting this method, the plurality noted that it would be extremely difficult to obtain the appropriate

58. See *id.* at 485 (Thomas, J., concurring) (emphasis added) (quoting the plurality and dissenting opinions).

59. *Id.* at 483 (Stevens, J., plurality opinion).

[B]ecause so many judges who have considered the issue (including the authors of the four earlier opinions in this case) have rejected the risk-free approach, we think it too late in the day to endorse that approach now. Of course, if the text of the statute required such an approach, that would be the end of the matter. We think, however, that § 1325(a)(5)(B)(ii)’s reference to “value, as of the effective date of the plan, of property to be distributed under the plan” is better read to incorporate all of the commonly understood components of “present value,” including any risk of nonpayment.

*Id.* (quoting 11 U.S.C. § 1325(a)(5)(B)(ii) (2004)).

60. See *In re Till*, 301 F.3d 583, 593–99 (7th Cir. 2002) (Rovner, J., dissenting) (proposing the cost of funds approach); Brubaker, *supra* note 32, at 5 (“Another approach to cramdown interest rates that seems untenable after *Till* is the so-called cost of funds approach.”).

61. See *Till*, 541 U.S. at 478 (Stevens, J., plurality opinion) (arguing that the “cost of funds approach imposes a significant evidentiary burden, as a debtor seeking to rebut a creditor’s asserted cost of borrowing must introduce expert testimony about the creditor’s financial condition”).

62. See Brubaker, *supra* note 32, at 6 (arguing that a major problem with the cost of funds approach is its unstated “assumption that the secured creditor has an unlimited supply of credit” (quoting *United Carolina Bank v. Hall*, 993 F.2d 1126, 1130 (4th Cir. 1993))).

63. *Till*, 541 U.S. at 478.

64. See *id.* at 477 (Stevens, J., plurality opinion) (explaining the considerations that led the plurality to “reject the coerced loan, presumptive contract rate, and cost of funds approaches”); *id.* at 491–92 (Scalia, J., dissenting) (adopting the contract rate approach to the exclusion of all other methods).

market rate of interest for a so-called “coerced loan” because there is “no free market of willing cram down lenders.”<sup>65</sup> Furthermore, although much of the dissenting opinion is consistent with the rationale behind the coerced loan approach, the main advantage of the presumptive contract rate technique advocated by the dissent is that the parties have already established an appropriate rate that takes into account all of the nuances of their own situation.<sup>66</sup> This is an advantage not shared by the coerced loan approach.<sup>67</sup> Additionally, it is clear that Justice Thomas would reject this method because it includes something beyond the risk-free rate.<sup>68</sup>

### III. ANALYSIS OF THE TWO METHODS LEFT STANDING AFTER *TILL*

#### A. *The Formula Approach*

##### 1. Basic Operation

The formula approach to calculating discount rates endorsed by the *Till* plurality takes “its cue from ordinary lending practices” by using the national prime rate as reported daily in the press as a starting point in the calculations.<sup>69</sup> Although the prime rate is actually the financial markets’ rate for the most creditworthy commercial borrowers,<sup>70</sup> it is commonly used as an index for consumer transactions (e.g., credit card rates). The prime rate of interest is a

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65. *Id.* at 476 n.14.

66. *See id.* at 491–92 (Scalia, J., dissenting) (explaining the assumptions underlying the presumptive contract rate approach and arguing that the contract rate “will provide a quick and reasonably accurate standard” because that rate reflects a bargain that the parties already entered into and therefore “is generally a good indicator of actual risk”); *id.* at 477 (Stevens, J., plurality opinion) (“[T]he coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors—an inquiry far removed from such courts’ usual task of evaluating debtors’ financial circumstances and the feasibility of their debt adjustment plans.”); *see also* Brubaker, *supra* note 32, at 7 (“While much of the reasoning of *Till*’s four-justice dissent is consistent with the forced loan theory, nowhere does that opinion expressly invoke the new loan analogy.”).

67. *Id.*

68. *See Till*, 541 U.S. at 487 (Thomas, J., concurring) (arguing that the statute at issue does not require that the interest rate in a cram down plan reflect the risk of nonpayment, and further asserting that in “most, if not all, cases, where the plan proposes simply a stream of cash payments, the appropriate risk-free rate should suffice”).

69. *Id.* at 478–79.

70. *See* BLACK’S LAW DICTIONARY 818 (7th ed. 1999) (defining the term “prime rate” as the “interest rate that a commercial bank holds out as its lowest rate for a short-term loan to its most creditworthy borrowers”).

combination of the risk free-rate<sup>71</sup> plus an additional 2-3% that serves as a risk premium.<sup>72</sup> The risk-free portion of the rate is supposed to compensate the lender for the opportunity cost of making the loan (i.e., the time value of money). The risk premium portion of the prime rate is included because of the risk that the debtor might default. This risk, however, is relatively low for creditworthy commercial borrowers, which is why the prime rate is only a few points higher than the equivalent treasury rate.<sup>73</sup>

Chapter 13 debtors pose a greater risk of nonpayment than do creditworthy commercial borrowers, which is why the formula approach augments the prime rate with an additional risk premium.<sup>74</sup> Calculating this addition to the prime rate requires the bankruptcy court to consider factors that one would expect to influence the likelihood that a confirmed Chapter 13 plan will succeed.<sup>75</sup> According to Justice Stevens, these factors include "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."<sup>76</sup> In the end, the calculation necessitates an evidentiary hearing at which both the creditors and debtor can present evidence that bears on the appropriate risk premium.<sup>77</sup>

One of the noteworthy aspects of the formula approach is that it starts from a "concededly *low* estimate" (the prime rate of interest) and requires the creditor to provide evidence in order to make an upward adjustment.<sup>78</sup> This has the practical effect of placing the evidentiary burden on creditors in almost every case.<sup>79</sup> Justice Stevens justified this burden-shifting by pointing out that creditors have better access to this type of information and that the factors

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71. The risk-free rate is generally represented by the treasury rates for relevant maturities.

72. The treasury rates do not include a risk premium because the market treats U.S. government bonds as default-free.

73. Note that the risk premium is actually composed of a premium for several different kinds of risk, e.g., inflation risk, reinvestment risk, etc., but this discussion focuses on the primary component of the premium which is the portion for default risk. Also note that some of the premium is designed to cover lender transaction costs, but details about these costs are outside the scope of this discussion.

74. See *Till*, 541 U.S. at 479 (Stevens, J., plurality opinion) ("Because bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers, the approach then requires a bankruptcy court to adjust the prime rate accordingly.").

75. *Id.*

76. *Id.*

77. *Id.*

78. *Id.* The burden will almost always be on the creditors because it is extremely unlikely that the debtor could present any evidence that the appropriate rate should be lower than the already debtor-favorable rate the court will start with.

79. *Id.*

considered when calculating the appropriate risk adjustment fall within the bankruptcy court's area of expertise.<sup>80</sup>

The most controversial aspect of the formula approach is determining the proper scale for the risk adjustment. The Court in *Till* approved a risk premium over the prime rate of 1.5%, and it appears that other courts have stayed within a 1-3% window.<sup>81</sup> The difficulty is that the rate selected must fully compensate the creditor for the default risk in order to meet the statutory mandate that the secured creditor receive property with a value at least equal to that of the allowed secured claim.<sup>82</sup> If the rate is too low, underestimating the risk of the plan's failure, the secured creditor will actually receive property that is worth less than its secured claim. However, if the rate is too high, it might doom the plan altogether (i.e., the debtor might not be able to afford to make the required payments and will be forced to surrender the collateral).<sup>83</sup> In the words of Justice Stevens, if the bankruptcy court determines that the likelihood of default is "so high as to necessitate an 'eye-popping' interest rate . . . the plan probably should not be confirmed."<sup>84</sup>

## 2. The Case for the Formula Approach

One of the primary reasons Justice Stevens endorsed the formula approach was because he believed the coerced loan, presumptive contract rate, and cost of funds approaches were all seriously flawed and therefore untenable.<sup>85</sup> He argued that these approaches were "complicated, impose[d] significant evidentiary costs, and aim[ed] to make each individual creditor whole rather than to ensure the debtor's payments have the required present value."<sup>86</sup> In contrast with these other approaches, the formula approach is

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80. *Till*, 541 U.S. at 479.

81. *Id.* at 480; see *In re Valenti*, 105 F.3d 55, 64 (2nd Cir. 1997) (holding that a risk premium "range of one to three percent is reasonable"); *In re Wilmsmeyer*, 171 B.R. 61, 63 (Bankr. E.D. Mo. 1994) (adopting a cram down interest rate of prime plus 3.5% set by a local rule that stands absent "proof to the contrary"); Connolly, *supra* note 24, at 20 (explaining that although "the Stevens opinion did not decide the 'proper scale' for the risk adjustment . . . it did cite to cases approving a risk adjustment (in unrelated fact patterns) of 1% to 3%").

82. See 11 U.S.C. § 1325(a)(5)(B)(ii) (2006) (requiring that "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").

83. See *Till*, 541 U.S. at 480 (stating that the court is obligated to "select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan").

84. *Id.* at 480-81 (citation omitted).

85. See *id.* at 477 (listing the considerations that led to the plurality's rejection of these methods).

86. *Id.*

straightforward and uses a procedure that is familiar to the financial markets.<sup>87</sup> Furthermore, the formula approach applies objective elements such as the national prime rate of interest, whereas the other techniques require a much more subjective analysis.<sup>88</sup>

Stevens was also swayed by the fact that the formula approach “minimizes the need for potentially costly additional evidentiary proceedings.”<sup>89</sup> While an evidentiary hearing will be necessary in order to determine the appropriate risk premium under the formula approach, the evidence that is required will, to some degree, already be included in the debtor’s bankruptcy filings.<sup>90</sup> Additionally, since the components of the formula approach missing from the debtor’s filings are easily obtainable (e.g., the national prime rate of interest as of the filing date), Stevens argued that debtors will incur comparatively less expense than if the other methods were used.<sup>91</sup>

The plurality opinion also argued that unlike the other methods endorsed by lower courts, the formula approach does not rely on creditors’ circumstances or on prior interactions between the creditor and the debtor.<sup>92</sup> These kinds of considerations do not address the statutory mandate of making sure that the present value of the payments to be received as part of the bankruptcy plan is equal to the allowed secured claim.<sup>93</sup> In contrast, the formula approach focuses on the state of the financial markets, the circumstances of the bankruptcy estate, and the characteristics of the proposed payments.<sup>94</sup> These are all factors that, according to Justice Stevens, directly influence the present value of the payment stream.<sup>95</sup>

There are several other implicit reasons the plurality opinion favored the formula approach. First, for the majority of Chapter 13 debtors, the risk premium calculated by the formula approach is systematically lower than the rate produced by the other methods.<sup>96</sup>

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87. *Id.* at 478–79.

88. *See id.* at 479 (“[T]he formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings.”).

89. *Id.*

90. *Id.*

91. *Id.*

92. *Id.*

93. *See* 11 U.S.C. § 1325(a)(5)(B)(ii) (2006) (requiring that “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”).

94. *Till*, 541 U.S. at 479–80.

95. *Id.*

96. For example, the Court approved a 9.5% interest rate for the *Tills* in spite of the fact that before they had a bankruptcy in their credit history (which negatively impacts one’s credit score) they agreed to a 21% rate. *Id.* at 470–71.

In reality, most Chapter 13 debtors were considered high credit risks before they filed for bankruptcy, and the risk they pose is not any lower in the eyes of creditors after they seek bankruptcy protection, at least not for the duration of the plan.<sup>97</sup> As a result, the methods that incorporate the original contractual rate of the loan (e.g., the presumptive contract rate approach), or what a creditor would now charge a debtor in similar circumstances (e.g., the coerced loan approach), produce a rate that is commonly two to three times larger than the current prime rate.<sup>98</sup> There is little doubt that one of the primary concerns of the plurality was that if these “eye-popping” rates are used, very few debtors will be able to propose a feasible plan because such a significant amount of their payments will have to go towards interest.<sup>99</sup> The impact of earmarking an unfair portion of the debtor’s assets for secured creditors is significant for several reasons. First, it would cause unsecured creditors to receive even less than they already appear to get on average. Second, it might make Chapter 13 prohibitively expensive for some debtors that are already precluded from using Chapter 7 by the “means test” added by the Act, which would leave the debtor with no avenue of relief from creditor harassment. Thus, the plurality may well have been concerned that forcing debtors to pay such high rates of interest would effectively negate the availability of Chapter 13 and give secured creditors more protection than the Code demands.<sup>100</sup>

Finally, the plurality seems to have endorsed the formula approach in part because there is not enough information available to *calculate* the appropriate risk premium. In other words, the presumptions and burdens of proof used in this method make it the most viable of the options, even if its accuracy in any specific situation is questionable.<sup>101</sup> In fact, the plurality opinion conceded that the rate

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97. *See id.* at 493 (Scalia, J., dissenting) (“[A]n already bankrupt borrower has demonstrated a financial instability and a proclivity to seek legal protection that other subprime borrowers have not.”). Note, however, that there are instances where declaring bankruptcy can actually improve a debtor’s credit risk, such as when a consumer successfully completes a Chapter 7 proceeding and thereby eliminates all of her creditors’ claims.

98. The majority of methods in use prior to *Till* would have yielded a rate of 21% or more, whereas the formula approach generated a 9.5% rate. *See id.* at 471–73, 479–80 (acknowledging that more than one of the lower courts held that a 21% rate was appropriate, but nevertheless approving the 9.5% rate generated by the formula approach).

99. *Id.* at 480–81 (citation omitted).

100. *See id.* (stating that the challenge is to “select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan” and arguing that “[i]f the court determines that the likelihood of default is so high as to necessitate an ‘eye-popping’ interest rate . . . the plan should probably not be confirmed” in the first place) (citation omitted).

101. *See id.* at 480 (stating that while there “is some dispute about the true scale” of the risk that the plan will fail, the Court “need not resolve that dispute”).



of failure for confirmed Chapter 13 plans was uncertain but claimed that it did not need to resolve that dispute in order to decide the case.<sup>102</sup> To anyone who was under the impression that the plurality was “calculating” an appropriate risk premium, this statement would be shocking. The most plausible explanation, however, is that the Justices concluded that the true risk of failure could not be accurately calculated using the available data. Consistent with this theory, the plurality’s endorsement of the formula approach seems to be a declaration that the debtor should get the benefit of the doubt if the real risk of default cannot be known.

### 3. Criticisms

The gravest flaw in the formula approach is that it does not comply with the Code’s mandate that secured creditors receive property that equals or exceeds the value of their allowed secured claims.<sup>103</sup> As the plurality opinion admits, a “debtor’s promise of future payments is worth less than an immediate payment of the same total amount because the creditor cannot use the money right away, inflation may cause the value of the dollar to decline before the debtor pays, and there is *always some risk of nonpayment*.”<sup>104</sup> This means that if the debtor’s plan provides that a stream of payments will pay off a secured claim, the payments must possess the same present value as a lump sum pay-off.

In order for the present value of these two options to be equal, the plan must include a rate of interest that sufficiently compensates the creditor for the opportunity cost of waiting to be paid, the risk of inflation over the payment period, and the risk of nonpayment.<sup>105</sup> As a practical matter, if all confirmed Chapter 13 plans succeeded according to schedule, the risk-free rate of interest on similar maturity treasury bills or bonds would be sufficient to compensate the creditor for the opportunity costs of making the loan.<sup>106</sup> However, as the

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102. *Id.*

103. See 11 U.S.C. § 1325(a)(5)(B)(ii) (2006) (requiring that “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”).

104. *Till*, 541 U.S. at 474 (emphasis added).

105. In fact, there are other components of market risk that should be included in the discussion if the goal is to actually simulate a market risk, e.g., reinvestment risk. While for the most part these risks are outside the scope of this discussion, they will be discussed in more detail in Parts IV & V, *infra*.

106. The plurality actually claims in footnote 18 that if the payments were certain the prime rate alone would be sufficient, but that would actually overcompensate the creditor because the prime rate includes a small default risk premium. *Till*, 541 U.S. at 479 n.18. In truth, the risk-free rate of interest does not actually compensate for inflation risk, so if there was no default risk

plurality concedes, even though the “post[-]bankruptcy obligor is no longer the individual debtor but the court-supervised estate,” the risk of default does not disappear and is only “somewhat reduced.”<sup>107</sup>

It becomes painfully obvious that the plurality either intentionally or mistakenly understated the impact of default risk when it declared that while there “is some dispute about the true scale of that risk,” it “need not resolve that dispute.”<sup>108</sup> Justice Stevens half-heartedly justified this assertion with his observation that “a court may not approve a plan unless, after considering all of the creditors’ objections and receiving the advice of the trustee, the judge is persuaded that ‘the debtor will be able to make all payments . . . and [otherwise] comply with the plan.’”<sup>109</sup> While this is no doubt a true statement, it has little to do with the risk of plan failure *after* the plan has been confirmed. In fact, the only way to know the appropriate risk premium when using the formula approach is to have some form of reliable estimate of both the failure rate of confirmed plans and the expected recovery rate for creditors when a confirmed plan fails. Without such information, the plurality’s confirmation of a 1.5% risk premium lacks any substantive support.

Along with underestimating the impact of default risk for Chapter 13 plans, the formula approach fails to meet the plurality’s own goal of creating an objective inquiry. While obtaining the current prime rate is an objective exercise, calculating the additional risk premium is far from objective. As the plurality concedes, the bankruptcy court must hold an evidentiary hearing under this approach to evaluate subjective factors that influence the likelihood of the plan’s success.<sup>110</sup> In addition, the plurality mistakenly assumes that the adjustment will always be smaller than the prime rate itself. Certainly there *could* be cases in which a Chapter 13 plan appears to have great chances of success, and in which the augmentation might be less than the prime rate itself (e.g., the 1-3% range the plurality notes other courts have used).<sup>111</sup> As a practical matter however, the average risk of plan failure appears to be very high, which means that the risk premium would in many cases be larger than the prime rate

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in confirmed Chapter 13 plans perhaps the more accurate statement would be to say that the creditor should receive the rate currently being paid on the most analogous inflation-indexed U.S. government bonds.

107. *Id.* at 475.

108. *Id.* at 480.

109. *Id.* (citation omitted).

110. *Id.* at 479.

111. *See id.* at 480 (“[O]ther courts have generally approved adjustments of 1% to 3%.”).

itself, assuming fundamental financial principles are not ignored.<sup>112</sup> As Justice Scalia phrased it, in many cram down proceedings the prime rate “becomes the objective tail wagging a dog of unknown size.”<sup>113</sup>

One final criticism of the Court’s adoption of the formula method is that the plurality essentially made policy when it endorsed this approach. In most Chapter 13 cases, the amounts at stake are relatively small in comparison to the costs of completing a detailed risk analysis.<sup>114</sup> Therefore, due to the costs associated with obtaining a better rate under the formula approach, most creditors will be stuck with little more than the prime rate of interest. In choosing to start from a low estimate and forcing the creditor to bear the costs of proving that it should be higher, the Court forces creditors to accept a rate that does not fairly compensate them for the risks they must bear.

### *B. The Presumptive Contract Rate Approach*

#### 1. Basic Operation

The presumptive contract rate approach, endorsed by Justice Scalia in his dissenting opinion, also recognizes that in order to comply with the Bankruptcy Code, a secured creditor receiving a stream of payments as part of a cram down plan should be compensated for the risk of default.<sup>115</sup> The contract rate method, however, begins with the presumption that the contractual rate the lender and debtor originally agreed upon properly compensates the lender for that risk.<sup>116</sup> This contractual rate only operates as a rebuttable presumption, however, and either party can present evidence that relates to the riskiness of the payments in an attempt to have a different rate applied.<sup>117</sup> In general, evidence bearing on “(1) the probability of plan failure; (2) the rate of collateral depreciation;

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112. See *id.* at 499 (Scalia, J., dissenting) (arguing that “risk premiums, if properly computed, would typically be substantial” and noting that if the 21% contractual rate in *Till* is an accurate reflection of risk in this case, the risk premium of 13% would represent nearly two-thirds of the total interest rate).

113. *Id.*

114. See *id.* at 500 (“[T]he costs of conducting a detailed risk analysis and defending it in court are prohibitively high in relation to the amount at stake in most consumer loan cases.”).

115. See *id.* at 491 (noting that the dissent and plurality “agree that any deferred payments to a secured creditor must fully compensate it for the risk that [a default] will occur”).

116. *Id.* at 492.

117. *Id.*

(3) the liquidity of the collateral market; and (4) the administrative expenses of enforcement” would be relevant to calculating a new rate.<sup>118</sup>

The presumptive contract rate approach requires two very important assumptions. First, this approach only works if the subprime lending market is efficient.<sup>119</sup> If the market is efficient and therefore competitive, then the rates that the subprime lending market charges consumer borrowers should consist only of the risk-free rate, the risk premium, and a small amount for transaction costs.<sup>120</sup> If, on the other hand, the subprime lending markets are not efficient, then the rates consumers are charged on their loans might represent more than just an amount necessary to compensate the lender for its risk (e.g., extra “interest” that represents pure profit).<sup>121</sup> Therefore, only if the market is competitive will the contractual rate represent an accurate estimate of the risk premium that the debtor should be charged.<sup>122</sup>

The second major assumption of the contract rate approach is that the expected costs of default in Chapter 13 would be roughly the same as they were at the time of the original loan.<sup>123</sup> The expected costs depend on both the likelihood of plan failure and the expected recovery rate for the secured creditor in the event of default.<sup>124</sup> In Justice Scalia’s dissent, he acknowledges that there is uncertainty about both of these factors because of a lack of relevant empirical

118. *Id.* at 499.

119. *See id.* at 492 (stating that the contract-rate approach “assumes that subprime lending markets are competitive and therefore largely efficient”). Although most often discussed in the context of publicly-traded securities’ prices, a market’s efficiency is generally a measure of how close existing prices are to the prices that would be in place if all of the relevant actors had access to the same information. *Cf.* JAMES D. COX ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 99 (4th ed. 2004).

A workable definition of an efficient market focuses on the relationship between price and information. A security’s price can be seen as being established in an efficient market if, with respect to specific information, the price that exists for the security is the same as the price it would have if everyone had the same information.

*Id.*

120. *See Till*, 541 U.S. at 492 (asserting that if the subprime lending markets are efficient, “the high interest rates lenders charge reflect not extortionate profits or excessive costs, but the actual risks of default that subprime borrowers present”).

121. *Id.* at 481–82 (Stevens, J., plurality opinion) (arguing that the existing regulation of subprime lending “evinces regulators’ belief that unregulated subprime lenders would exploit borrowers’ ignorance and charge rates above what a competitive market would allow”).

122. *See id.* at 492 (Scalia, J., dissenting) (conceding that the contractual rate would not provide a “reasonably accurate standard” if the subprime lending markets were not “competitive and therefore largely efficient”).

123. *Id.* at 492–93.

124. *See id.* at 503–04 (calculating the expected costs by multiplying the chance of failure by the total costs in the event of default).

data.<sup>125</sup> In light of this uncertainty, however, he endorses the presumptive contract rate method because as a practical matter, he believes that the contractual rate is a better estimate of the appropriate risk premium than the prime rate of interest, which only incorporates a low level of risk.<sup>126</sup>

## 2. The Case for the Presumption Approach

The main reason that the dissenting Justices endorsed the presumptive contract rate approach in lieu of the other methods is that they believed it provided the most realistic means of enforcing the goals of the Code.<sup>127</sup> This perception is based on the notion that the promised stream of payments that comprise the cram down plan will only be worth the entire amount of the allowed claim if the plan provides for a risk premium that is large enough to wholly cover the risk that the debtor will default again.<sup>128</sup> Furthermore, calculating the exact risk and expected recovery rate in any single case in order to come up with an appropriate risk premium might be more expensive than the actual claim itself, so the best source for reaching a conclusion as to the appropriate risk premium is not the bankruptcy court, but the financial markets. Determining the market rate for these loans is complicated by the fact that unlike in Chapter 11, where a market exists for loans made to debtors-in-possession, there is no real market for loans to Chapter 13 debtors.<sup>129</sup> Therefore, according to this method, the best available indication of the market rate for Chapter 13 debtors is the rate that they agreed to in the first place.<sup>130</sup>

According to Justice Scalia, another benefit of the presumptive contract rate approach is that since this rate will generally provide a good estimate of the appropriate risk premium, disputes between the

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125. *Id.* at 493 & n.1 (noting that very few empirical studies on the success rates of Chapter 13 plans have been completed).

126. *See id.* at 504 (arguing that the "1.5% premium adopted in this case is far below anything approaching fair compensation").

127. *See id.* at 508 ("Because I read the statute to require full risk compensation, and because I would adopt a valuation method that has a realistic prospect of enforcing that directive, I respectively dissent.").

128. *See id.* at 504 (arguing that the 1.5% premium adopted by the plurality falls short of compensating the creditor for the full amount of default risk it is being forced to bear).

129. *See, e.g., id.* at 476 n.14 (Stevens, J., plurality opinion).

[W]hen picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to . . . ask only what rate will fairly compensate a creditor for its exposure.

*Id.*

130. *Id.* at 491–92 (Scalia, J., dissenting).

debtor and creditors on this issue will be relatively rare.<sup>131</sup> In fact, because the parties have already agreed to the rate at least once before, it is likely that they will be willing to accept the rate again, thus streamlining the bankruptcy process by eliminating the evidentiary hearing in most cases. In fact, the only time that there would need to be an evidentiary hearing is if either party had compelling evidence that the default risk or expected costs of default were significantly different from when they first entered into the contract, a rare occurrence according to the dissent.<sup>132</sup>

In a related vein, the dissent also seems to have endorsed this method because of the belief that the formula approach systematically under-compensates creditors.<sup>133</sup> As a practical matter, if a debtor posed enough of a risk of default before he or she declared bankruptcy to make a 17% risk premium appropriate,<sup>134</sup> it is virtually certain that after the debtor initiates bankruptcy proceedings the appropriate risk premium would generate a cram down rate *at least* equal to the original contractual rate.<sup>135</sup>

Justice Scalia also argued that the *Till* issue does not force the Court to choose between one method that always provides too low of an estimate and another that consistently guesses too high.<sup>136</sup> Instead, the choice between the methods is, according to him, one between a rate that is obviously too low and one that is almost always going to be within an acceptable range.<sup>137</sup> Furthermore, the danger of selecting the method which results in a rate that is always too low is that in many cases the amounts in dispute will be small enough that it will not be financially feasible for the creditors to fight the issue.<sup>138</sup> If secured creditors are systematically undercompensated, they will have to make adjustments in their lending policies to other subprime borrowers. These adjustments will take the form of even higher rates or, in states where the rates are already limited by law, fewer loans

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131. *Id.* at 492.

132. *See id.* (arguing that if the contract rate is adopted, “disputes should be infrequent, and it will provide a quick and reasonably accurate standard”).

133. *Id.* at 491–92.

134. This premium was calculated by subtracting the risk-free rate at the time the Tills borrowed (approximately 4.13%) from the contractual rate of 21%.

135. Liz Pulliam Weston, *Beef up Your Credit Score in 5 Steps*, MSN MONEY, Oct. 2, 2005, <http://moneycentral.msn.com/content/Banking/Yourcreditrating/P38052.asp> (explaining that bankruptcy is the “nuclear bomb of the credit world” as it “can knock 200 points, or more, off the score of someone with otherwise good credit”).

136. *Till*, 541 U.S. at 500 (Scalia, J., dissenting).

137. *Id.* at 491–92.

138. *See id.* at 500 (arguing that the plurality’s approach smacks of policymaking because the “costs of conducting a detailed risk analysis and defending it in court are prohibitively high in relation to the amount at stake in most consumer loan cases”).

will be made to similarly situated borrowers.<sup>139</sup> As Justice Scalia noted, “widespread access to credit is worth preserving, even if it means being ungenerous to sympathetic debtors.”<sup>140</sup>

### 3. Criticisms

The fundamental problem with the presumptive contract rate approach is that it assumes a very high rate of interest is appropriate without any quantitative support for this conclusion.<sup>141</sup> Although the expected rate and costs of default *could* be similar in pre- and post-bankruptcy scenarios, the Court in *Till* did not have enough information to know whether that is actually the case.<sup>142</sup> For example, although Justice Scalia discussed the possible default rates for Chapter 13 plans, he never discussed the Tills’ expected default rate at the time they took out the original loan.<sup>143</sup> Thus, there is no basis for comparison. As a result, although Justice Scalia used the 37% rate of failure that the Tills provided for the sake of his example, the opinion did not provide any way of actually knowing whether that rate was higher or lower than the default rate Instant Auto Finance expected at the time it made the loan. Without any actual information on this point, the dissent’s adoption of this method seems to be more of a guess in favor of secured creditors than a reasoned conclusion.

The second basic problem with the contract rate approach is that it puts the burden of proof on the debtor in the majority of cases. As Justice Stevens pointed out, any information that is not already included in the bankruptcy filings which have been prepared by the debtor’s representative is almost certainly more available to the creditor, which must have the information in order to stay competitive within its market.<sup>144</sup> If the debtor must, as a practical matter under this approach, always be the party that presents evidence in an

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139. See *id.* at 508 (“If subprime lenders are systematically undercompensated in bankruptcy, they will charge higher rates or, if they already charge the legal maximum under state law, lend to fewer of the riskiest borrowers.”).

140. *Id.*

141. See Craig Rankin & Christopher Alliotts, *The Importance of ‘Till’*, NAT’L L.J., Sept. 6, 2004, at 13, 13 (“[T]he contract rate approach appears to be somewhat draconian when applied to the debtors in *Till*.”).

142. See *Till*, 541 U.S. at 504 (Scalia, J., dissenting) (admitting that “many of the estimates [the dissenting opinion has] made can be disputed” but arguing that “[w]hen a risk premium is off by an order of magnitude, one’s estimates need not be very precise to show that it cannot possibly be correct”).

143. See generally *id.* at 491–508 (utilizing the risk premium incorporated in the contractual rate as a basis of comparison without discussing the corresponding default rate).

144. *Id.* at 484 (Stevens, J., plurality opinion).

attempt to lower the interest rate,<sup>145</sup> the resources expended to do so will come at the expense of unsecured creditors who already receive an incredibly small percentage of their claims.

A final criticism of the presumptive contract rate approach is that the dissent's assumption that the subprime lending market is competitive and therefore largely efficient<sup>146</sup> is questionable. First, if subprime borrowers had any real bargaining power (as they generally would in a competitive market) it would be difficult to explain why several states have found it necessary to enact usury laws limiting the maximum amount of interest creditors can charge.<sup>147</sup> The most obvious explanation for these laws is that the state legislatures believed that lenders in the subprime lending markets "would exploit borrowers' ignorance and charge rates above what a competitive market would allow" if left unregulated.<sup>148</sup> Justice Scalia's response to this argument is that the subprime market must be competitive because subprime lenders are twice as likely to be unprofitable as prime lenders, and he cited a study to illustrate this point.<sup>149</sup> There are two primary problems with this conclusion, however. First, other research has reached the opposite result, namely that subprime lenders actually tend to be more profitable than prime lenders.<sup>150</sup> Second, the tie between expected revenues and bottom-line profits is more complicated than Justice Scalia implies, and subprime lenders' tendency to be unprofitable could be explained in a multitude of other ways.<sup>151</sup> Finally, Justice Scalia's argument that relying on the efficiency of the subprime lending market is no more of a stretch than relying on the efficiency of the prime market is unconvincing because the two markets operate in substantially different ways. For example,

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145. Creditors would not usually challenge the rate calculated by this method for two reasons: (1) they would know that getting an even higher rate would be extremely unlikely; and (2) they have already accepted the rate as compensation for the risk of nonpayment previously, and although it might not be completely accurate considering the unique risks of the bankruptcy plan failing, it will almost always be enough to make the creditor acquiesce.

146. *Till*, 541 U.S. at 492 (Scalia, J., dissenting).

147. *See, e.g., id.* at 482 n.22 (Stevens, J., plurality opinion) (listing examples of usury laws).

148. *Id.* at 482.

149. *Id.* at 492 (Scalia, J., dissenting).

150. *See* Deanna Thompson, *Subprime Not Necessarily Sub Profits*, *BUS. J.*, Oct. 6, 2000, available at [http://www.bizjournals.com/triad/stories/2000/10/09/focus2.html?jst=s\\_rs\\_hl](http://www.bizjournals.com/triad/stories/2000/10/09/focus2.html?jst=s_rs_hl) (noting that although prime banks were traditionally hesitant to enter the subprime lending market, interest suddenly spiked when they discovered that margins were in the neighborhood of nine percent).

151. For example, subprime lenders might tend to be smaller, less-established companies that were quickly formed to take advantage of the incredibly favorable interest rate conditions of the early 2000s. If this were the case, it would not be surprising that many of them were not particularly well-run and became unprofitable when the interest rate environment changed.



the prime rate of interest is published daily in many national newspapers so it would be extremely difficult for any prime rate lender to charge more than the market rate without the borrower knowing.<sup>152</sup> On the other hand, the market rate for subprime consumer borrowers is a much more fact-specific calculation that incorporates, among other factors, the borrower's credit rating, income, and other debts.<sup>153</sup> As a result, it is not as easy for consumers to compare the interest rate they are offered to what other similarly situated consumers are receiving.

#### IV. SECURITIZATION DATA: WHAT DO THE NUMBERS SAY?

##### *A. Till Addresses the Wrong Problem*

As previously discussed, the formula and presumptive contract rate approaches, as well as the Supreme Court opinions endorsing them, remain unconvincing for many reasons.<sup>154</sup> In the aftermath of *Till*, a majority of legal academics remain split along the same lines they were previously. In fact, many of the articles written about *Till* basically assert that the case failed to decide anything.<sup>155</sup> As a practical matter, there is little hope that a resolution of this tension will ever be possible if the issue continues to be framed as a choice between the two approaches discussed in Part III of this Note. This concern serves as the impetus for this Note's thesis, which is that both the *Till* opinions and the ongoing debate about these methods start with the wrong question.

Further discussion of this issue should begin with the determination of whether using the educated guess methods analyzed in *Till* is even necessary. The goal in all of this is to calculate the

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152. See, e.g., *Money Rates*, WALL ST. J., Feb. 18, 2005, at B5 (listing the prime rate, "[t]he base rate on corporate loans posted by at least 75% of the nation's largest 30 banks," as 5.5%, effective 2/2/05).

153. See Wells Fargo, *What Lenders Consider*, [http://www.wellsfargo.com/credit\\_center/use\\_credit/buy\\_home/lenders\\_consider?requestid=79485](http://www.wellsfargo.com/credit_center/use_credit/buy_home/lenders_consider?requestid=79485) (last visited Jan. 31, 2006) (noting that consumer lenders base decisions on five factors: "income stability, the debt-to-income ratio, the loan-to-value (LTV) ratio, property appraisal, and credit history.").

154. See discussion *supra* Part III.

155. See, e.g., Brubaker, *supra* note 32, at 1 ("[T]here is little in *Till* to guide and constrain the lower courts, aside from the pre-*Till* circuit precedent not inconsistent with *Till*."); Yerbich, *supra* note 13, at 10 (noting that although *Till* will most likely be interpreted by lower courts as setting the prime rate as the starting point, the actual impact still hinges on the risk premium adjustment, "and on this point, *Till* provides no assistance whatsoever. Indeed, *Till* does not even tell us who has the burden!").

present value of a stream of future payments.<sup>156</sup> Unless one is prepared to challenge fundamental financial principles, the discount rate calculation should be simply a function of the risk-free rate and an appropriate risk premium for the specific loan in question.<sup>157</sup> Outside of bankruptcy, this type of calculation takes place millions of times a day. Lenders have developed scoring systems which estimate the risks that individual borrowers pose by comparing their characteristics to those of past borrowers who have defaulted. This simple observation begs the question: why is the Supreme Court arguing over whether the contractual rate or the prime rate is a more accurate *guess* instead of just trying to calculate the appropriate rate, which should be a function of the plan's risk?<sup>158</sup>

The most likely response to this question is that conducting such an analysis would be prohibitively expensive due to the dearth of information on the success rates of Chapter 13 bankruptcy plans, as well as the lack of public information about the success rates of loans made outside of bankruptcy.<sup>159</sup> Therefore, some would argue that the bankruptcy courts simply must use the best estimate available instead of trying to calculate the risk premium on a case-by-case basis.<sup>160</sup> Furthermore, proponents of the *Till* methods claim that unnecessary unfairness is avoided due to the fact that either party can introduce evidence as to an appropriate adjustment to the presumed rate.<sup>161</sup>

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156. See *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 957 (1997).

Under the cram down option, the debtor is permitted to keep the property over the objection of the creditor; the creditor retains the lien securing the claim . . . , and the debtor is required to provide the creditor with payments, over the life of the plan, that will total the present value of the allowed secured claim.

*Id.* (citation omitted).

157. See *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004) (Stevens, J., plurality opinion) (explaining that the components of the prime rate include a charge "for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default").

158. For those who would disagree with this characterization of the *Till* debate, the plurality is refusing to calculate the likelihood of success which is absolutely necessary to figure out if the risk premium is appropriate, and the dissent is using a rate that represents the likely success of the original loan instead of the bankruptcy plan.

159. See, e.g., *Till*, 541 U.S. at 477, 479 (Stevens, J. plurality opinion) (criticizing approaches that attempt to determine comparable market rates as being "complicated" and "impos[ing] significant evidentiary costs" and claiming that one of the virtues of the formula approach is that it "minimizes the need for potentially costly additional evidentiary proceedings"); *id.* at 480 (admitting that "[t]here is some dispute about the true scale" of the risk that the plan will fail).

160. See *id.* at 491 (Scalia, J., dissenting) (framing the dispute between the *Till* dissent and plurality as being over "what procedure will more often produce accurate *estimates* of the appropriate interest rate") (emphasis added).

161. See *id.* at 479 (Stevens, J., plurality opinion) ("The court must therefore hold a hearing at which the debtor and any creditors may present evidence about the appropriate risk adjustment."); *id.* at 498 (Scalia, J., dissenting) ("If a judge thinks it necessary to modify the rate to avoid unjustified disparity, he can do so.").

In the end, some or all of the above assertions may be true. However, considering the stakes involved, these contentions should not be accepted without scrutiny. The *Till* debate up to this point seems to have accepted these conclusions as gospel, which is why the remainder of Part IV lays out some of the available information and takes a hard look at whether calculating risk premiums in bankruptcies would be plausible, or, alternatively, whether there is enough information to at least test the accuracy of the educated guess methods used in *Till*.

### B. Gathering the Available Data

The problem inherent in calculating the appropriate risk premium actually results from two separate dilemmas. First, in spite of the fact that there have been millions of Chapter 13 cases, there is very little empirical data on the historical success and recovery rates for such plans.<sup>162</sup> If such information were available, calculating the appropriate risk premium for any given Chapter 13 plan could be analogous to how such a premium would be calculated outside of bankruptcy.

The second informational problem is the perceived lack of available data about success and recovery rates for loans made outside of bankruptcy. Even if the historical results of Chapter 13 plans were not available, this second kind of data would enable bankruptcy courts to compare loan situations that were sufficiently analogous to the *de facto* loan at issue and thus generate an estimate of the going market rate for such a loan.

The resort to the presumptive contract rate and formula approaches is strong evidence that courts dealing with this issue have concluded that neither of the above kinds of information is obtainable in sufficient quantities. However, while the existing empirical data about Chapter 13 plans leaves much to be desired, there is a significant amount of available information concerning loans made outside of bankruptcy that could be extremely useful in a risk premium analysis.

A plentiful source of such information can be found in the securitization industry, which has surprisingly been ignored by previous courtroom and academic discussions of the *Till* issue. To securitize is to "convert (assets) into negotiable securities for resale in

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162. See, e.g., *id.* at 485 (Stevens, J., plurality opinion) (describing the data uncovered by the dissent as "rather sketchy"); *id.* at 493 n.1 (Scalia, J., dissenting) (discussing the two available empirical studies on the success rates of confirmed Chapter 13 plans).

the financial market.”<sup>163</sup> One of the most common types of assets to securitize is loans generated by financial institutions, a large portion of which are consumer automobile loans.<sup>164</sup> In fact, institutions such as General Motors Acceptance Corporation (“GMAC”) and Capital One Auto Finance securitize pools made up entirely of either prime or subprime consumer automobile loans.<sup>165</sup> Although it is still a relatively new development in the world of finance, securitization has become a useful tool for many companies and an absolute staple in certain industries.<sup>166</sup>

Securitization data is relevant to this analysis because these pools of loans are being converted into securities for public sale, and, as a result, information must be filed with the Securities and Exchange Commission (“SEC”).<sup>167</sup> As part of the required SEC disclosures, the issuing companies divulge the historical losses and delinquency rates of loans similar to those which make up the collateral. As will be seen in the next Section, this information

163. BLACK’S LAW DICTIONARY 1358 (7th ed. 1999).

In a typical securitization transaction, the company originating, or sponsoring, the transaction (hereinafter, the “originator”) sells rights to payment from income-producing financial assets, such as accounts receivable, loans, or lease rentals (collectively, “financial assets”), to a special-purpose entity or vehicle—variously referred to as an “SPE” or “SPV” (this article uses the latter term)—which in turn transfers such rights to a second SPV. The second SPV issues securities to capital market investors and uses the proceeds of the issuance to pay the first SPV for the financial assets; the first SPV then uses those proceeds to pay the originator. The investors in the securities are repaid from collections of the financial assets. They therefore buy the securities based on their assessments of the value of the financial assets. The relationship between the originator and the investors is arm’s length and independent.

Steven L. Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1540 (2004).

164. See, e.g., FITCH RATINGS, A ROAD MAP TO RATING AUTO LOAN-BACKED SECURITIZATIONS 1 (2002), available at [http://www.fitchratings.com/corporate/reports/report\\_frame.cfm?rpt\\_id=139756&sector\\_flag=1&marketsector=2&detail=](http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=139756&sector_flag=1&marketsector=2&detail=) (“Since the inception of the asset-backed securities (ABS) market, auto-backed securitization has been a vital part of total ABS volume.”).

165. See, e.g., FITCH RATINGS, AUTO-BACKED ABS: 2003 REVIEW AND 2004 OUTLOOK 13, 15 (2004), available at [http://www.fitchratings.com/corporate/reports/report\\_frame.cfm?rpt\\_id=195304&sector\\_flag=1&marketsector=2&detail=](http://www.fitchratings.com/corporate/reports/report_frame.cfm?rpt_id=195304&sector_flag=1&marketsector=2&detail=) [hereinafter AUTO-BACKED ABS] (charting the cumulative losses of ABS securitizations issued by GMAC (prime) and Capital One (subprime)).

166. See Schwarcz, *supra* note 163, at 1541.

Securitization has unquestionable benefits. It enables the originator to obtain lower-cost financing through disintermediation by removing the need for intermediaries, such as banks, that separate the originator from the ultimate source of funds, the capital markets. It increases liquidity and better allocates risk and its distribution. It also enables the originator to “deploy scarce and costly capital to other portions of its business that may be in need of it.” To this extent, at least, it is viewed as socially desirable.

*Id.* (internal citations omitted).

167. See, e.g., 15 U.S.C. § 77(e) (2006) (prohibiting the sale or delivery of securities unless a registration statement covering the securities is in effect).

provides interesting comparisons for the Chapter 13 risk premium analysis.

### *C. Presentation of the Findings*

In order to avoid data skewed by abnormal securitization issues in favor of information representative of the subprime and prime consumer automobile lending markets generally, more than one hundred securitizations of automobile loans were reviewed for this Note. In the end, twenty-six prime and twenty-seven subprime securitization issues were selected.<sup>168</sup> Each issue discussed in this

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168. All of the following prospectuses are available at <http://www.sec.gov/edgar.shtml>. Prime securitizations selected for this Note are as follows: Chase Manhattan Auto Owner Trust 2003-B, Prospectus (Form 424b), at S-14 (July 25, 2003); Chase Manhattan Auto Owner Trust 2003-A, Prospectus (Form 424b5), at S-14 (May 27, 2003); Chase Manhattan Auto Owner Trust 2002-B, Prospectus (Form 424b5), at S-14 (June 4, 2002); Chase Manhattan Auto Owner Trust 2002-A, Prospectus (Form 424b2), at S-14 (Mar. 4, 2002); Chase Manhattan Auto Owner Trust 2001-B, Prospectus (Form 424b2), at S-15 (Nov. 5, 2001); Chase Manhattan Auto Owner Trust 2001-A, Prospectus (Form 424b2), at S-13 (July 19, 2001); Chase Manhattan Auto Owner Trust 2000-A, Prospectus (Form 424b5), at S-14 (Dec. 6, 2000); DaimlerChrysler Auto Trust 2003-B, Prospectus (Form 424h5), at S-7 (Dec. 2, 2003); DaimlerChrysler Auto Trust 2003-A, Prospectus (Form 424b5), at S-7 (Aug. 19, 2003); DaimlerChrysler Auto Trust 2002-B, Prospectus (Form 424b5), at S-7 (Aug. 22, 2002); DaimlerChrysler Auto Trust 2002-A, Prospectus (Form 424b5), at S-7 (Aug. 8, 2002); DaimlerChrysler Auto Trust 2001-B, Prospectus (Form 424b5), at S-7 (June 4, 2001); Ford Credit Auto Owner Trust 2003-B, Prospectus (Form 424b2), at S-7 (Mar. 26, 2003); Ford Credit Auto Owner Trust 2003-A, Prospectus (Form 424b2), at S-7 (Mar. 26, 2003); Ford Credit Auto Owner Trust 2002-D, Prospectus (Form 424b2), at S-7 (June 13, 2002); Ford Credit Auto Owner Trust 2002-C, Prospectus (Form 424b2), at S-7 (June 13, 2002); Ford Credit Auto Owner Trust 2002-B, Prospectus (Form 424b2), at S-7 (Mar. 12, 2002); Honda Auto Receivables 2003-4 Owner Trust, Prospectus (Form 424b5), at S-23 (Oct. 29, 2003); Honda Auto Receivables 2003-3 Owner Trust, Prospectus (Form 424b5), at S-23 (Aug. 19, 2003); Honda Auto Receivables 2003-1 Owner Trust, Prospectus (Form 424b5), at S-23 (Feb. 24, 2003); Honda Auto Receivables 2002-4 Owner Trust, Prospectus (Form 424b5), at S-23 (Nov. 18, 2002); Honda Auto Receivables 2002-3 Owner Trust, Prospectus (Form 424b5), at S-23 (July 18, 2002); Honda Auto Receivables 2002-2 Owner Trust, Prospectus (Form 424b5), at S-23 (May 17, 2002); Honda Auto Receivables 2002-1 Owner Trust, Prospectus (Form 424b5), at S-23 (Jan. 25, 2002); Honda Auto Receivables 2001-3 Owner Trust, Prospectus (Form 424b5), at S-23 (Oct. 16, 2001); Honda Auto Receivables 2001-2 Owner Trust, Prospectus (Form 424b5), at S-22 (July 20, 2001). Subprime securitizations selected for this Note are as follows: AmeriCredit Automobile Receivables Trust 2003-D-M, Prospectus (Form 424h5), at S-22 (July 10, 2003); AmeriCredit Automobile Receivables Trust 2003-C-F, Prospectus (Form 424b5), at S-19 (July 10, 2003); AmeriCredit Automobile Receivables Trust 2003-B-X, Prospectus (Form 424b5), at S-19 (Jan. 25, 2003); AmeriCredit Automobile Receivables Trust 2003-A-M, Prospectus (Form 424b5), at S-19 (Jan. 25, 2003); AmeriCredit Automobile Receivables Trust 2002-E-M, Prospectus (Form 424b5), at S-19 (Jan. 25, 2002); AmeriCredit Automobile Receivables Trust 2002-D, Prospectus (Form 424b5), at S-20 (Jan. 25, 2002); Capital One Auto Finance Trust 2003-B, Prospectus (Form 424b5), at S-17 (Nov. 4, 2003); Capital One Auto Finance Trust 2003-A, Prospectus (Form 424b5), at S-17 (May 14, 2003); Capital One Auto Finance Trust 2002-C, Prospectus (Form 424b5), at S-15 (Dec. 2, 2002); Capital One Auto Finance Trust 2002-B, Prospectus (Form 424b5), at S-16 (June 14, 2002); Capital One Auto Finance Trust 2002-A, Prospectus (Form 424b5), at S-13 (Apr. 15, 2002); Capital One Auto Finance Trust 2001-B, Prospectus (Form 424b5), at S-15 (Dec. 11, 2001); Capital One Auto

Note was picked for two primary reasons: (1) the securitization's prospectus was available on the SEC's website; and (2) the selected issues were included in Fitch Rating's industry-wide index for such securitizations.<sup>169</sup> The data garnered from this research includes the average annual percentage rates, default rates, terms, and net losses of the consumer automobile loans that make up the asset pool. The information is laid out in Tables 1 and 2, below.

Table 1: Data from 2000-2003 Prime Securitizations

	Honda	Chase	DaimlerChrysler	Ford	Weighted Averages
Issues	9	7	5	5	Total Issues = 26
Average APR (%)	5.80	7.17	6.60	5.58	6.28
Rate of Default (%)	1.17	2.06	2.42	3.12	2.02
Average Term (Months)	56.63	58.31	59.39	56.46	57.58
Loss Rate (%)	0.32	0.55	0.92	1.53	0.73
Calc. Rec. Rate (%)	72.54	73.58	62.12	50.96	65.75

Finance Trust 2001-A, Prospectus (Form 424b5), at S-12 (July 10, 2001); Household Automotive Trust 2003-2, Prospectus (Form 424b5), at S-17 (Oct. 28, 2003); Household Automotive Trust 2003-1, Prospectus (Form 424b5), at S-17 (May 27, 2003); Household Automotive Trust 2002-3, Prospectus (Form 424b5), at S-17 (Nov. 25, 2002); Household Automotive Trust 2002-2, Prospectus (Form 424b5), at S-15 (Aug. 26, 2002); Household Automotive Trust 2002-1, Prospectus (Form 424b5), at S-15 (May 29, 2002); Household Automotive Trust 2001-3, Prospectus (Form 424b2), at S-15 (Oct. 19, 2001); Household Automotive Trust 2001-2, Prospectus (Form 424b2), at S-14 (July 19, 2001); Household Automotive Trust 2001-1, Prospectus (Form 424b2), at S-11 (Mar. 2, 2001); Household Automotive Trust VI Series 2000-3, Prospectus (Form 424b2), at S-11 (Aug. 31, 2000); Household Automotive Trust V Series 2000-2, Prospectus (Form 424b2), at S-10 (June 15, 2000); Triad Automobile Receivables Trust 2004-A, Prospectus (Form 425b5), at S-16 (Mar. 15, 2004); Triad Automobile Receivables Trust 2003-B, Prospectus (Form 425b5), at S-14 (Oct. 27, 2003); Triad Automobile Receivables Trust 2003-A, Prospectus (Form 425b5), at S-14 (Mar. 26, 2003); Triad Automobile Receivables Trust 2002-A, Prospectus (Form 425b2), at S-13 (Aug. 19, 2002).

169. See AUTO-BACKED ABS, *supra* note 165, at 12-16 (providing charts that display the performance of these securitizations during 2003).

Table 2: Data from 2000-2003 Subprime Securitizations

	Capital				Weighted Averages
	AmeriCredit	One	Household	Triad	
Issues	6	7	10	4	Total Issues = 27
Average APR (%)	16.60	15.24	17.47	16.99	16.63
Rate of Default (%)	11.43	9.49	12.21	13.40	11.51
Average Term (Months)	63.67	63.29	63.96	66.22	64.06
Loss Rate (%)	4.25	4.85	6.02	6.15	5.34
Calc. Rec. Rate (%)	62.80	48.89	50.72	54.10	53.43

As can be seen from the above tables, the weighted average default rate for prime consumer automobile loans is 2.02%, and the same rate for subprime consumers is 11.51%. These percentages are not reported directly in every one of the SEC filings used for this analysis. In fact, in half of the issues studied here (those by Ford, Chase, AmeriCredit, and Triad), the disclosures included the number of delinquent contracts over the total number of contracts outstanding, which is what this analysis uses as the rate of default.<sup>170</sup> However, in the other half of the issues (those by Honda, DaimlerChrysler, Capital One, and Household Finance), the information only included the average annual amount of past due payments (both principal and interest) divided by the average outstanding principal.<sup>171</sup> While this number is conceptually different than the rate of default, review of the SEC disclosures that contain both types of data reveals that on average this number is only about 6.65% lower than the rate of default.<sup>172</sup> Therefore, for the second four securitization issuances, the delinquency rates provided were adjusted upwards by 6.65%. As one can see from looking at Tables 1 and 2, this small adjustment left the corresponding default rates within the range of those for which direct numbers were disclosed.

170. See sources cited *supra* note 168.

171. *Id.*

172. *Id.* Expressing default percentages in these two different ways (defaulted contracts versus defaulted principal) does not result in wildly different outcomes because the loan amounts for these securitizations do not vary significantly.

The last lines of Tables 1 and 2 must also be explained in more detail. In order to present data that has any real explanatory power, one needs the average recovery rate in the event of default, a number which is not disclosed directly in any of the SEC filings used in this analysis.<sup>173</sup> However, the filings do disclose the number that is listed in the second to last line in Tables 1 and 2, which is the net loss rate. This number is the percentage of outstanding principal that must be written off on a yearly basis, net of recoveries from prior write-offs. In order to calculate the average recovery rate using this information, this analysis makes the reasonable assumption that the net loss rate is simply a function of the default rate multiplied by the average loss in the event of default. Therefore, the average recovery rate used in this analysis was calculated using the following formula:

$$(1 - p) * (1 - \gamma) = \text{NLR}^{174}$$

“NLR” represents the net loss rate discussed above (which is given in the filings), “(1 - p)” is the probability of default, and “(1 -  $\gamma$ )” represents the expected loss in the event of default, where “ $\gamma$ ” itself is equal to the expected recovery rate. The results of this calculation for the data presented are located in the last row of both Tables.

#### *D. A Different Kind of Formula Approach*

In order to explain the relationship and relevance of the data presented in the previous Section to the issue in *Till*, the following formula will be used to demonstrate, on a very simple level, how different rates of default and expected losses affect the appropriate risk premium:

$$E(r) = (p) (1 + k) + (1 - p) * \gamma^{175}$$

“E(r)” is the expected return on a loan in which “k” is equal to the total interest rate charged to the borrower. “(1 - p)” and “ $\gamma$ ”

173. *Id.*

174. As net loss rate includes both losses for the year and recoveries from previously written off accounts, it is not as helpful for explanatory purposes in this analysis. Therefore, the formula presented here is simply another way of expressing the same number, that is, as a matter of basic algebra, the overall loss rate for the year must be a function of the probability of default multiplied by the average loss in the event of default. As the add-backs of previously written off accounts are generally negligible, this analysis assumes that they are constant on a yearly basis and therefore does not separately take them into account, but rather leaves them incorporated into the overall net loss rate.

175. As was the case with the previous formula, this is simply a statement of basic algebraic principles, that is, the expected return from a loan in a simple two-state world (assuming there is only one payment period and only two possible outcomes) is simply the probability of the first outcome multiplied by the result of that outcome plus the probability of the second outcome multiplied by the result of that outcome.



represent the same concepts they did in the previously explained formula.<sup>176</sup> Again, this formula simply represents the expected return given the probabilities of the two possible outcomes; therefore, it makes several simplifying assumptions.<sup>177</sup>

### *E. Application of the Collected Data*

In order to see how well the above formula performs in explaining the relationship between default rates, expected losses assuming default, and default risk premiums, the data collected and explained in Section C will be used to calculate a predicted risk premium for the prime and subprime automobile loans. This prediction will then be compared to the actual average annual percentage rate of the loans within the securitizations that is reported in the SEC filings. As was mentioned previously, the equation makes several simplifying assumptions, the most notable of which is that there is only one payment period. Therefore, even though the calculation will use interest rates that are applicable to multi-year loans, to keep calculations as simple as possible, it assumes that there is only one period. The predicted risk premiums for the prime and subprime loans are contained in Table 4, below:

Table 3: Rates Used in the Calculations

	Dec-00	Dec-01	Dec-02	Dec-03	Averages
2-Year Treasury Rate	5.35	3.11	1.84	1.91	3.05
5-Year Treasury Rate	5.17	4.39	3.03	3.27	3.97
Prime Rate	9.50	4.84	4.25	4.00	5.65

176. See *supra* Part IV.C.

177. While these assumptions should not be ignored, the purpose of this Note is not to incorporate every possible variable, but rather to provide an understandable example of how securitization data could be added to the cram down mix in order to come up with a more accurate method of calculating risk premiums.

**Table 4: Results of Applying the Probabilities Formula: Predicted Risk Premiums**

	Prime (%)	Subprime (%)
W.A. Rate of Default	2.02	11.51
W.A. Recovery Rate	65.75	53.43
App. Risk-Free	3.97	3.97
Predicted Rate	4.75	10.53
Predicted Risk Prem.	.79	6.57
Average APR	6.28	16.63
Unpredicted Premium	1.53	6.09

As Table 4 demonstrates, using the information collected from the SEC filings and the appropriate risk-free rate of interest as the expected return, the formula predicted a contractual rate of 4.75% for prime auto loans and 10.53% for those that are subprime. When compared to the average five-year treasury rate over the same time period, these predicted rates would provide creditors with a .78% risk premium for prime loans, and 6.56% for subprime loans.

As is apparent from Table 4, both sets of numbers are lower than the average annual percentage rate of the loans that made up the securitization asset pools. In the case of prime loans, Table 4 shows that the average rate of interest charged to prime borrowers is approximately 1.5% higher than the predicted rate, and the average rate charged to subprime borrowers is approximately 6.1% higher than the rate predicted by the formula.

There are several possible explanations for these discrepancies. The first potential explanation is that the equation being used in this analysis, and its simplifying assumptions, creates a margin of error that leads to systematically low risk premiums. However, an equally plausible reason that the predicted rates are lower than the actual rates charged to consumers is that the formula being used in this analysis is only designed to calculate the premium necessary to compensate creditors for default risk and does not take into account other forms of risk, transaction costs, and profit margins, the combination of which could make up the entire difference between the rates. In other words, as far as the market for consumer automobile loans is concerned, creditors will demand more than just compensation for the time value of money (which would simply be the risk-free rate). Furthermore, even the risk-free rate plus sufficient compensation for the risk that the debtor could default will not be enough (which would be the rate predicted by the formula). In fact,

the market appears to require an extra 1.5%-6% of contractual interest depending on the credit rating of the consumer to compensate for things such as transaction costs, prepayment risk, reinvestment risk, inflation risk, etc. The important lesson to take away from these results is that if one simply applied the formula used in this analysis to create the contractual rate of interest on a loan, he or she would, if anything, undercompensate the creditor as compared to the going market rate.

## V. SOLUTION: CALCULATING CHAPTER 13 CRAM DOWN RATES

As was explained in Part III, the fundamental flaw in the approaches endorsed by both the plurality and dissenting opinions in *Till* is that they simply guess at the correct risk premiums in lieu of providing quantitative support for their conclusions.<sup>178</sup> Both of the opinions amounted to concessions that the true risk premiums for Chapter 13 cram down plans could not be calculated. Thus, the real dispute centered around what the presumption should be, even though in most cases neither party would be able to present enough evidence to change it. As a result, the *Till* issue simply must be revisited because the educated guess approaches of both the plurality and dissent simply do not comply with the Code.

### A. Comparing Data

Though not abundant, there certainly appears to be enough information about the success rates of Chapter 13 bankruptcy plans to know that both of the *Till* approaches have missed the mark. As both the plurality and dissenting opinions note, there appears to be only two studies that shed any light on how often confirmed Chapter 13 plans succeed. The first, referred to as the Girth study, yields a post-confirmation failure rate of 37%.<sup>179</sup> Of course, the predictive value of this number is somewhat questionable when one realizes that it is over twenty years old and was calculated using data from a single district.<sup>180</sup> The Norberg study also tackles the issue of Chapter 13 success rates, and while it is more recent, it also uses information that

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178. See *Till v. SCS Credit Corp.*, 541 U.S. 465, 491 (2004) (Scalia, J., dissenting) ("Our only disagreement is over what procedure will more often produce accurate estimates of the appropriate interest rate.").

179. *Id.* at 493 n.1.

180. *Id.*

is geographically limited.<sup>181</sup> Nevertheless, the Norberg study yields a post-confirmation failure rate of a whopping 60%.<sup>182</sup>

Although there is a need for further research in this area before the debate can be settled for good, the numbers that are available at this point clearly indicate that it is an extremely risky proposition to rely on the success of a Chapter 13 plan. In fact, even the lower of the two available Chapter 13 failure rates is three times as high as the default rates for subprime automobile loans. This is where the information presented in Part IV becomes particularly helpful. One can discern from that data that an average default rate of 11.51% and recovery rate of 53.43% yields an average risk premium of 6.57% according to the simple probabilities formula. Furthermore, and perhaps more importantly, the financial markets appear to require a risk premium of 12.66% according to the average APR of the subprime loans. Without any further calculation, it becomes clear that Chapter 13 plans should require a risk premium that is greater than that of the loans making up the subprime securitizations because the bankruptcy failure rate is so much higher. At this point, it is helpful to remember that the *Till* plurality confirmed a Chapter 13 bankruptcy plan with a risk premium of just 1.5%,<sup>183</sup> an inexplicably low number in light of the preceding observations. To further illustrate this point, Table 5 uses the formula presented in Part IV to calculate the expected risk premium using the available Chapter 13 information.

Table 5: Applying the Probabilities Formula to Bankruptcy

	Girth (%)	Norberg (%)
Rate of Failure/Default	37.00	60.00
Assumed Recovery Rate	53.43	53.43
App. Risk-Free Rate	5.35	5.35
Calculated Rate	35.84	83.23
Risk Premium	30.49	77.88

As Table 5 shows, even using the failure rate from the more optimistic Girth study, the formula used in Part IV of this Note predicts that in order to compensate a creditor for the default risk of a Chapter 13 plan, the nominal rate of interest charged to the debtor would have to be 35.84%! Of course, if that number seems high, using

181. *Id.*

182. *Id.*

183. *Id.* at 480 (Stevens, J., plurality opinion).

the data from the Norberg study results in what would seem to be an outright absurd 83.23%.

What makes these results even more stunning is that they only represent the rates necessary to compensate creditors for the default risk of Chapter 13 plans. In order to get a true "market" rate for this type of loan, one would have to add to these already unconscionable rates at least a portion of the unpredicted premium discussed in Part IV.

### *B. Implications*

The above calculations have been presented simply to show the inherent problem with the Supreme Court's attempt to comply with the Bankruptcy Code by guessing at the appropriate risk premium. Although these results could certainly be used to make the blanket argument that Chapter 13 secured creditors are systematically undercompensated, that is not the intention of this Note. In fact, if the rates calculated above were actually applied, the simple reality is that many debtors would find Chapter 13 to be prohibitively expensive and therefore useless. This effect, in combination with the Act's severe limitations on the availability of Chapter 7, could mean that some consumer debtors would be left without any useful form of bankruptcy relief, a result most agree would cause serious societal problems.

Instead, the presentation of these findings constitutes an attempt to show that there is enough information available to know that the methods used in *Till* fail to comply with the Bankruptcy Code. As was mentioned earlier, the primary reason bankruptcy courts began using the *Till* methods was the perceived lack of information regarding Chapter 13 success rates and the default and recovery rates of loans made outside of bankruptcy.<sup>184</sup> The conclusion that there is a lack of information about Chapter 13 plans was almost certainly correct. As a result, it would be a mistake to simply use the default rates from the two available empirical studies along with the probabilities formula from Part IV to actually calculate the rate that an individual debtor should have to pay to retain his assets. However, the conclusion as to the lack of comparative data seems to have been premature. Using the information presented in Part IV as an example, it appears obvious that despite the *Till* methods' appeal as simplistic solutions, they are much too inaccurate to be accepted as a necessary solution to the problem of how to calculate cram down rates.

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184. See *supra* Part IV.A.

Therefore, to appropriately settle the *Till* issue for good, one of two things must happen: either a comprehensive study on the success rates of confirmed Chapter 13 plans should be conducted or the Bankruptcy Code should be amended. As to the comprehensive study option, admittedly, there are major barriers to such a study being accomplished. However, if the results were objectively verifiable, then the analysis could be conducted by a number of different groups.<sup>185</sup> Upon the completion of such a study, bankruptcy courts would have much more reliable estimates of default rates for Chapter 13 plans, which would mean that the calculation of cram down rates in bankruptcy could be as easy as applying the formula discussed in Part IV. This type of study would also enable the bankruptcy courts to evolve beyond using the simple formula presented in this analysis and instead develop a scoring system for Chapter 13 debtors that would be analogous to the systems that have been engineered by the credit industry to assess the likelihood of default outside of bankruptcy.<sup>186</sup> Although it would take time and probably require some trial and error, such a system would allow courts to *calculate* the appropriate risk premium for any given Chapter 13 plan. Such a calculation process would reduce the need for evidentiary hearings as to the appropriate risk premium in any single case, and would thus streamline the bankruptcy process. Most importantly, however, this type of calculation would reach a much more objective result than those currently being used and would also avoid the problem of systematically placing the burden of proof as to the correct rate on one of the parties.

If it is determined that a study of Chapter 13 success rates is not possible, then the bankruptcy courts that confirm Chapter 13 cram down plans will continue to violate the clear language of the Bankruptcy Code until the Code itself is amended.<sup>187</sup> The simple financial fact is that if one does not know how risky a stream of future payments is, the present value of those payments cannot be accurately calculated. The Code's mandate that a cram down plan not be confirmed unless the secured creditor receives at least the value of its

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185. Examples of such groups include but are not limited to legislative committees, legal academics, the credit industry, and debtor advocate groups.

186. See, e.g., MyFICO, *How Credit Scoring Helps You*, <http://www.myfico.com/CreditEducation/ScoringHelps.aspx> (last visited Jan. 31, 2006) ("Credit scores give lenders a fast, objective measurement of your credit risk. Before the use of scoring, the credit granting process could be slow, inconsistent and unfairly biased.").

187. Of course, the Code was amended in the spring of 2005, but this issue amazingly escaped the attention of Congress. Although some would argue that the inaction by members of Congress on this matter is a sign of implicit approval of the *Till* result, I counter that their inaction was simply a result of their haste to satisfy their constituencies.

secured claim<sup>188</sup> requires that the court know the present value of the promised payments before confirmation. The fact that creditors and debtors have the “opportunity” to present evidence that the risk premium presumptions of the court are incorrect<sup>189</sup> does not solve the problem because holding such an evidentiary hearing is, in most cases, prohibitively expensive for either party. Therefore, if the success rates of Chapter 13 plans cannot be calculated, the Code should reflect the fact that creditors will not necessarily be receiving the full value of their claim if they are required to accept a stream of future payments in lieu of a lump-sum payment at the time of confirmation.

## VI. CONCLUSION

The Supreme Court in *Till* was faced with a split of opinion on how to calculate discount rates for Chapter 13 cram down plans. Without addressing the issue, the Court accepted the implicit assumption of lower courts that calculation of risk premiums, and therefore discount rates, was impossible on a case-by-case basis because of the lack of necessary information. As a result, the Court framed the issue as a choice between the methods used by lower courts without truly addressing the possibility that they all fail to comply with the Bankruptcy Code. Framed in this manner, it is not surprising that the Justices ended up splitting four-four-one. Furthermore, because Justice Thomas simply concurred with the method that resulted in the lower risk premium in the specific case before the Court, it is entirely possible that if the Court were to take up the issue again the dissent and plurality could switch roles.

In the aftermath of the *Till* decision, there has been significant academic commentary criticizing its outcome and arguing that one of the *Till* methods should be adopted over the others.<sup>190</sup> This Note breaks from that commentary by proposing that none of the *Till* methods amounts to a viable solution. To further this point, this Note utilizes loan data available in securitization disclosures as a basis of comparison, which leads to two primary conclusions. First, while

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188. See 11 U.S.C. § 1325(a)(5)(B)(ii) (2006) (“the value, as of the effective date of the plan, of property to be distributed under the plan on account of such [allowed secured] claim is not less than the allowed amount of such claim”).

189. See *Till v. SCS Credit Corp.*, 541 U.S. 465, 479 (2004) (Stevens, J., plurality opinion) (stating that “the debtor and any creditors may present evidence about the appropriate risk adjustment” at a hearing).

190. See Brubaker, *supra* note 32, at 1 (“there is little in *Till* to guide and constrain the lower courts, aside from pre-*Till* circuit precedent not inconsistent with *Till*”); Yerbich, *supra* note 13, at 10 (arguing that “[p]lurality pronouncements have long been the bane of lower federal courts in attempting to apply them”).

case-by-case risk premium calculation is possible, the limited data available at this point would make it hard to justify the sometimes draconian results it would produce. Second, in contrast to assumptions made by the *Till* Court, there *is* enough data to convincingly show that the educated guess methods debated in *Till* are inaccurate enough to seriously question their compliance with the Code.

As a result of these conclusions, the *Till* issue can be resolved in one of two ways. First, comprehensive studies on the success rates of Chapter 13 plans would enable bankruptcy courts to develop objective formulas for calculating cram down rates. Alternatively, if such studies are not possible, the Bankruptcy Code should be amended to reflect the financial reality that bankruptcy courts are currently confirming cram down plans without knowing whether secured creditors are being properly compensated.

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