Ch. 12 Ruling Is A Helpful Addition To Interest Rate Case Law

By **Donald Swanson** (September 29, 2023)

Which rate of interest should a debtor pay under a bankruptcy plan?

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On Aug. 2, the U.S. Court of Appeals for the Eighth Circuit addressed this question in In re: Topp. The petition for rehearing was denied Sept. 20.

Facts

Farmer William Topp was the In re: Topp debtor, raising crops and livestock. After several rough years, the farmer filed for Chapter 12 bankruptcy.

The creditor, Farm Credit Services of America, filed a $595,000 secured claim in the bankruptcy, based on five loans of various durations having interest rates of 3.5% to 7.6%.

The creditor's claims were fully secured by the farmer's real estate — valued at $1.45 million.

Topp's Chapter 12 plan proposed to pay the creditor's claim in full from future earnings, in 20 annual payments, with interest. The plan rate of interest was computed as starting with the 20-year treasury bond rate, which was 1.87% at the time, and adding a 2% risk adjustment.

The creditor agreed with the 20-year term of payments, and was even OK with the 2% risk adjustment.

But the creditor objected to starting with the 20-year treasury bond rate. The creditor insisted, instead, that the starting point should be the national prime rate, which was 3.25% at the time.

Legal Standard and Its Application

The legal standard is this: To be confirmed, over the creditor's objection, the plan must pay the creditor a total value, as of the effective date of the plan, that is not less than the allowed amount of the claim.[1]

In applying this standard, the U.S. Bankruptcy Court for the Southern District of Iowa sided with Topp on the treasury bond rate versus national prime rate issue, rounded 1.87% plus 2% up to 4% — finding this rate to be proper — and confirmed the plan with its 4% interest, over the creditor's objection.

The creditor appealed to the U.S. District Court for the Southern District of Iowa, which affirmed, and then to the Eighth Circuit — which also affirmed.

What follows is a summary of the Eighth Circuit's rationale for siding with Topp in approving the treasury bond rate starting point and adding a 2% risk adjustment.

Statutory Goal

The goal of the Chapter 12 confirmation statute is to ensure that the total present value of future plan payments to the creditor equals or exceeds the allowed value of the creditor's claim.

Since the creditor's claim is over-secured, its entire claim is allowed. But that doesn't mean the creditor is entitled to post-confirmation interest at the contract rates.

Interest Function

Money received now is worth more than money received later. So, interest is added to make future payments equal the present value of a claim.

And there are no guarantees in life. A lot can happen in 20 years, and deferred payments come with risk — e.g., the debtor may not be able to pay, market conditions may shift, etc.

So, interest accruals, at a proper rate, adjust and account for both the time value of money and the risk involved.

The Dispute

Topp and the creditor agreed that an interest rate determination calls for a market-rate or formula approach, which says the appropriate interest rate should consist of a low-risk or risk-free rate, plus additional interest to compensate for risks posed by the plan.

Where the disputing parties disagreed is over the proper low-risk or risk-free starting point: i.e., the treasury bond rate or the prime rate. Both rates are reported daily in publications such as the Wall Street Journal.

The case law that was cited for the dispute was the Eighth Circuit's 1989 opinion in United States v. Doud for the treasury rate by the debtor, while the creditor cited Till v. SCS Credit Corp., a 2004 U.S. Supreme Court decision, for the prime rate.

Choosing Treasury Rate

Neither Doud nor Till chose between the treasury rate or the prime rate.

Doud

Doud approved starting with the treasury rate. But Doud did not actually choose between competing starting points.

Doud affirmed the bankruptcy court's choice of an overall rate beginning with the treasury rate as not clearly erroneous, since the bankruptcy court provided a rational analysis of its preference for starting with the treasury rate.

This is appropriate because, around that time — the late 1980s and early 1990s — many courts were starting with the treasury rate before adjusting upward for risk.

Till

Till came later, in 2004.

Around that time, some courts were taking a nonformula approach. But Till's plurality favored the formula approach — characterized as beginning with the national prime rate and then adjusting upward for the risk of nonpayment in a bankruptcy.

But, like Doud, Till did not consider the merits of starting with the prime rate versus the treasury rate. Till's plurality discussed the prime rate simply because that is the formula approach used in that case.

As for the appropriate risk adjustment on top of the prime rate, the plurality did not decide: It merely observed that courts generally approve adjustments of 1% to 3%.

Starting and Adding

In Topp, the Eighth Circuit approved the treasury rate as an appropriate starting point for the formula approach, and added to that rate for the risk involved.

The treasury rate is entirely risk-free, whereas the prime rate includes an inherent risk of default in loans to the most creditworthy borrowers.

The error of the creditor's position was that, while agreeing with the bankruptcy court's 2% adjustment, the creditor wanted to start with the more favorable rate. But the creditor's approach was backwards — the starting point will influence the risk adjustment.

Moreover, there is no legal significance in starting with a risk-free rate and adding a full risk, or starting with a some-risk rate and adding some more. If a court properly follows the formula approach, the ultimate interest rate, not the starting point, is what matters.

In Till's wake, most courts start with the prime rate — but the treasury rate still persists.

Standard of Review

The creditor, in focusing on Till, attempted to get a more favorable standard of review. The creditor was pitching the starting-rate choice as a purely legal question, calling for de novo review.

But the starting rate choice is, actually, a factual finding about the appropriate interest rate — which choice is reviewed for clear error.

Ruling

In reviewing the bankruptcy court's factual findings for clear error, the Eighth Circuit saw none.

The bankruptcy court studied the Till-Doud relationship and the prevalence of post-Till decisions using the prime rate. The bankruptcy court also considered the length of the proposed maturity period, the fact that the creditor's claim was substantially over-secured, and the overall risk of nonpayment.

The bankruptcy court also noted that the creditor's claim was secured by real estate, which is generally financed over a long period of time — justifying the use of the treasury bond as the base rate.

In the end, the bankruptcy court approved a 4% rate — the treasury rate plus 2% for risk, which also happens to equal the prime rate of 3.25%, plus a modest risk adjustment of 0.75%.

Takeaways

Here are some takeaways from the Topp opinion.

The choice of a plan interest rate is a factual issue subject to appellate review for clear error — not a legal issue subject to de novo review.

The starting point for choosing a plan interest rate, under the formula approach, is the treasury rate, which has no risk, or the prime rate, which has limited risk, with additions from there based on risks and other factors involved.

In any situation, the end result should be about the same, whether the analysis starts with the treasury rate, and adds onto its no-risk rate, or starts with the prime rate, and adds on a smaller amount to the limited-risk rate.

Conclusion

The Eighth Circuit's Topp opinion is instructive and a helpful addition to the body of case law on interest rate provisions in bankruptcy plans.

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[1] § 1225(a)(5)(B)(ii).