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Alert

Second Circuit Endorses Market Interest Rate for Cramdown Plan in *Momentive*

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The United States Court of Appeals for the Second Circuit recently issued its long-awaited opinion stemming from the confirmed Chapter 11 plan of *Momentive Performance Materials Inc.*[1] The court reversed the lower courts' controversial holding that senior secured lenders receiving replacement secured notes under the debtors' plan were only entitled to interest at the "formula" rate — determined by using the risk-free rate plus a plan-specific risk adjustment. Instead, the Second Circuit remanded the case to the bankruptcy court with instructions to determine whether an efficient market rate exists, and if so, to apply that "market" rate to the replacement notes, and to use the "formula" rate only in the event there is no efficient "market" rate.

The Second Circuit's ruling is an important victory for secured lenders, who now will not have to risk being saddled with new debt instruments bearing below-market interest rates in a "cramdown" Chapter 11 plan scenario.

Background

In *Momentive*, the debtors' plan offered a choice to its senior secured lenders. The lenders could vote to accept the plan and receive full payment in cash, but would have to waive the right to seek payment of an asserted $200-million make-whole payment. Alternatively, they could vote to reject the plan, in which case they would receive replacement secured notes and retain the right to litigate the allowance of the make-whole claim. The lenders rejected the plan, opting instead to litigate the make-whole and challenge confirmation based on the proposed terms of the new notes. Ultimately, the bankruptcy court determined the lenders were not entitled to the make-whole payment, a decision subsequently affirmed by the district court.[2]

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[1] *Momentive Performance Materials Inc. v. BOKF, NA (In the Matter of: MPM Silicones, L.L.C.)*, --- F.3d ----, 2017 WL 4700314, No. 15-1682, (2d Cir. Oct. 20, 2017), available here.

[2] The Second Circuit affirmed the lower courts' decisions denying payment of the make-whole premium to the senior secured lenders. Relying on the Second Circuit's prior decision in *In re AMR Corp.*, 730 F.3d 88 (2d. Cir. 2013), the Second Circuit held that the senior secured lenders' debt had been automatically accelerated under the applicable indentures upon the bankruptcy filing, which changed the date of maturity of the accelerated notes to the petition date. Thus the plan could not have effectuated an optional redemption because a redemption could only occur at or before maturity. *Momentive*, at *11.

Note that in *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016), the Third Circuit held, in a similar case, that the debtors' refinancing of notes in bankruptcy constituted an "optional redemption" entitling noteholders to a make-whole premium despite the automatic acceleration of the notes as a result of the bankruptcy filing. Disagreeing with the lower courts' decision in *Momentive*, the Third Circuit found that a "redemption" would be unaffected by the acceleration of the maturity date and the make-whole was thus due and owing. *Id.* Both circuits agree, however, that a premium based on a "prepayment" will not be payable post-acceleration because acceleration advances the

To confirm the plan over the objection of the class of secured creditors (a so-called "cramdown" plan), the bankruptcy court first had to conclude that it was "fair and equitable." A plan is "fair and equitable" in its treatment of a class of secured creditors if it provides that the creditors will retain their liens and receive deferred cash payments with a "present value" equal to the amount of their secured claim.[3]

To ascertain the present value of the replacement notes, the bankruptcy court had to determine the appropriate interest rate, or discount rate, to apply to the future stream of payments under the notes. This led to a dispute as to the appropriate methodology for calculating the interest rate. The debtors advocated for the "formula" approach, which starts with a risk-free (or low-risk) base rate (such as the Treasury rate or prime rate) that is adjusted by the bankruptcy court — usually in the range of 1 percent to 3 percent — to account for risks based on the circumstances of the case, the nature of the collateral, the terms of the new note and the feasibility of the plan. In contrast, the senior secured lenders argued that the appropriate rate is the "market" rate, which refers to the interest rate the borrower would be required to pay for such financing in an efficient market.[4]

In rejecting the "market" approach in favor of the "formula" approach, the bankruptcy and district courts each relied on the plurality decision in *Till v. SCS Credit Corp.,* 541 U.S. 465 (2004). There the Supreme Court determined the "formula" rate was the appropriate interest rate in a Chapter 13 case[5] for a $4,000 secured claim that arose from a sub-prime auto loan. Using the "formula" approach in *Momentive*, the bankruptcy court ultimately selected interest rates between 4.1 and 4.85 percent for the two classes of senior secured notes, overruling the senior secured lenders' argument that an appropriate "market" rate would be in the 5 to 6+ percent range, which was based on rates the debtors had obtained from third parties for a committed exit facility in the event the senior lenders elected the cash out option. *Momentive*, at *7.

The senior secured lenders appealed the bankruptcy court's decision to the district court, which affirmed, and ultimately appealed to the Second Circuit.

Second Circuit's Decision

Interestingly, the Second Circuit also relied on the Supreme Court's decision in *Till*. It noted that the plurality in *Till* had "intimated that the 'formula' method might be applicable to rate calculations" in other Bankruptcy Code provisions and even cited the Chapter 11 cramdown provision (11 U.S.C. § 1129(b)(2)(A)(i)(II)). But the Second Circuit did not find that *Till* had provided a "conclusive statement" regarding the application of the "formula" rate in Chapter 11 cases. *Momentive*, at *8. The Second Circuit was particularly swayed by the oft-cited "footnote 14" of the *Till* decision, which contrasted cramdowns in the Chapter 13 context, where no efficient market for cramdown lenders exists with the Chapter 11 context where "numerous lenders advertise financing for Chapter 11 debtors in possession. Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." *Momentive*, at *8, *citing Till*, 541 U.S. at 476 n. 14.

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maturity date and prepayment can only occur prior to maturity. Parties can avoid the semantic battle over whether a post-maturity payment is a "prepayment" or "redemption" by drafting a clear right to the premium in a post-acceleration context.

[3] *See* 11 U.S.C. § 1129(b)(2)(A)(i).

[4] This argument appeared particularly compelling since the debtors had in fact arranged for new third-party financing to pay the secured lenders the cash consideration had they voted to accept the plan.

[5] *See* 11 U.S.C. § 1325(a)(5)(B)(ii).

The Second Circuit adopted the Sixth Circuit's two-part process, formulated in reliance on *Till*'s footnote 14, for selecting an interest rate in the Chapter 11 "cramdown" context. *Momentive*, at *8 *citing In re American HomePatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005). The Second Circuit held that the bankruptcy court must use the "market" rate where an efficient market exists, but, if no efficient market exists, it could use the "formula" approach from *Till*. *Momentive*, at *9. Markets have been determined to be "efficient" where "they offer a loan with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan." *Momentive*, at *8 *citing In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 337 (5th Cir. 2013).

The Second Circuit noted that the senior secured lenders had presented expert testimony in the bankruptcy court to establish a market rate, including having received quotes from other lenders to provide exit financing with interest rates ranging from 5 to 6 percent. *Momentive*, at *9. Thus, the Second Circuit remanded the case for the bankruptcy court to ascertain whether an efficient market rate exists and if so, to apply that rate, only using the "formula" rate where there is no efficient market.[6] *Id.*

Conclusion

The lower courts' decisions exposed secured creditors to a significant risk of being forced to accept replacement notes with a below-market interest rate in a cramdown plan. The Second Circuit's decision eliminates this risk so long as there is an ascertainable market rate. We suspect that the battle ground for cramdown plans will shift from the appropriate approach to calculating the interest rate to whether there exists an "efficient market" to determine a "market" rate. In *Momentive*, the existence of an efficient market appears indisputable because the debtors sought and obtained third-party commitments for exit financing. But it remains to be seen how the lower courts will determine cramdown interest rates where, unlike *Momentive*, the debtor does not seek third-party financing and the parties instead rely on dueling expert testimony.

Authored by Lawrence V. Gelber, Adam C. Harris, David M. Hillman and Lucy F. Kweskin.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the authors.

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[6] The court also held that despite the fact that the Plan had been consummated almost three years earlier, the senior secured lenders' appeal to the Second Circuit was not equitably moot because the lenders had diligently appealed the plan confirmation, including seeking a stay of the confirmation order. *Momentive*, at *12. Further, the court reasoned that the effect of re-evaluating interest on the replacement notes would require at most $32 million of payments over seven years and the debtors would not have to pay any make-whole premium. *Id.* at *13.