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Alert

District Court Affirms Cramdown Plan in *Momentive* Case

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The U.S. District Court for the Southern District of New York, on May 4, 2015, affirmed U.S. Bankruptcy Judge Robert D. Drain's decision confirming the reorganization plan for Momentive Performance Materials Inc. and its affiliated debtors.[1] The Bankruptcy Court's decision was controversial because it forced the debtors' senior secured creditors to accept new secured notes bearing interest at below-market rates. The secured creditors are expected to appeal to the U.S. Court of Appeals for the Second Circuit. This ruling is noteworthy (and troubling for secured creditors, especially those who provide financing to distressed companies) because it sets a road map for Chapter 11 debtors to pursue reorganization plans that seek to force secured lenders to accept new secured notes at below-market rates. And as troubling as that may be in a relatively low interest rate environment, this impact will be amplified as interest rates increase. Consequently, secured creditors will need to re-evaluate pricing to compensate for this increased risk.[2]

Formula Approach Versus Market Approach

In the *Momentive* case, the debtors proposed a reorganization plan that offered a choice to its senior secured creditors: (1) vote to accept the plan and receive full payment in cash, *but* waive the right to seek payment of a $200-million make-whole payment; or (2) vote to reject the plan and receive new secured notes and retain the right to litigate the allowance of the make-whole claim. The creditors voted to reject the plan, and the Bankruptcy Court determined they were not entitled to the make-whole. To confirm the plan over the objection of the class of secured creditors (a so-called "cramdown" plan), the Bankruptcy Court had to determine whether the plan 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: (1) retain their liens; and (2) receive deferred cash payments with a "present value" equal to the amount of their secured claim.[3] To determine the present value of the new notes, the Bankruptcy Court had to determine the appropriate interest, or discount, rate.

The dispute concerned the methodology for determining the interest rate on the new notes. There were two different approaches — the formula approach or the market approach. The "formula approach" starts with a risk-free (or low-risk) base rate (such as the Treasury rate or prime rate) and is adjusted by

[1] *See U.S. Bank Nat'l Ass'n v. Wilmington Savings Fund Society, FSB (In re MPM Silicones, LLC)*, No. 14-7471, slip op. (S.D.N.Y. May 4, 2015) ("Ruling").

[2] Our analysis of the lower court decision on the cramdown rate was the subject of a prior SRZ *Alert*, "Bankruptcy Court Approves Non-Market Cramdown Rate on Momentive Secured Creditors." The District Court also affirmed Judge Drain's decision to deny payment of a make-whole premium because the applicable credit documents did not clearly provide that payment was due after acceleration of the indebtedness.

[3] Ruling at 15-16; *see also* Bankruptcy Code § 1129(b)(2)(A)(i).

the Bankruptcy Court, in this case in the range of 1 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 feasibility of the plan.[4] The U.S. Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465, 479-80 (2004) approved the use of the formula approach in determining the cramdown rate on a new note given to an existing lender in a Chapter 13 consumer case where the note was secured by a used truck. The "market approach" refers to the rate of interest the debtor/borrower would be required to pay for the same financing in an efficient market.[5] In a footnote in *Till*, the Supreme Court noted that where there is a free market of willing debtors in possession and exit lenders, "it might make sense to ask what rate an efficient market would produce."[6]

In *Momentive*, there was indisputable evidence of the market rate because the debtors had obtained an exit facility commitment to refinance the secured debt in case the secured creditors voted in favor of the plan. The market rate on the committed exit facility was higher than the rate provided in the new notes under the plan. Judge Drain decided to apply the formula approach.

A summary of the existing debt and new notes is set forth below:

	Prepetition First Lien Notes	New First Lien Note		Prepetition 1.5 Lien Notes	New 1.5 Lien Note
Principal	$1 billion	$1 billion		$250,000	$250,000
Maturity	8 years (issued in 2012 and due in 2020)	7 years (issued in 2014 and due in 2021)		8 years due (issued in 2012 and due in 2020)	7.5 years (issued in 2014 and due in 2021)
Collateral	Blanket lien	Same		Blanket lien subordinate to first lien notes	Same
Interest Rate	8.875%	3.6% (7 year Treasury plus risk premium of 1.5%)		10%	4.1% (7.5 year Treasury plus risk premium of 2%)
		As compared to a market rate of 5%			As compared to a market rate of 7%

[4] Ruling at 17.

[5] *Id.* at 16-17.

[6] *Till*, 541 U.S. at 476 n.14.

District Court Affirms Use of Formula Approach

On appeal, the creditors argued that Judge Drain erred in applying the formula approach. They argued that the market approach, unlike the formula approach, was consistent with "basic principles of finance." Moreover, they posited, other courts have applied the market approach in corporate Chapter 11 cases after the Supreme Court's decision in *Till.*[7]

The District Court, like the Bankruptcy Court, rejected the market approach. The District Court held that the use of the market rate would: (1) impose "significant evidentiary costs" and would aim to "make each individual creditor whole rather than to ensure the debtor's payments have the required present value"; and (2) "overcompensate" creditors because it would cover lenders' transaction costs and profits, neither of which is relevant in the context of cramdown loans.[8]

The District Court further noted that consideration of the market was not required in Chapter 11 cases, and that the Bankruptcy Code did not require putting creditors "in the same position they would have been in had they arranged a new loan."[9] On this point, the District Court noted that the Second Circuit (a court whose decisions are binding on the District Court) had endorsed this reasoning in a pre-*Till* case. Specifically, in *In re Valenti*, 105 F.3d 55 (2d Cir. 1997), the Second Circuit had "rejected the efficient market approach," explaining that:

> [T]he cramdown interest rate is meant "to put the creditor in the same economic position that it would have been in had it received the value of its claim immediately. The purpose is *not* to put the creditor in the same position that it would have been in had it arranged a 'new' loan … [T]he value of a creditor's allowed claim does not include any degree of profit. There is no reason, therefore, that the interest rate should account for profit … Otherwise, the creditor will receive more than the present value of its allowed claim."[10]

The secured creditors also argued that the formula approach was misapplied. Specifically, they argued that Judge Drain erred in using the Treasury rate as the base risk-free rate, given that the higher prime rate (then 3.25 percent) had been applied by the Supreme Court in *Till*. Moreover, they argued that adding an "artificial" and "arbitrary" risk premium of 1 to 3 percent to that base rate was also wrong.

The District Court rejected these arguments, stating that the Bankruptcy Court was not required under *Till* to choose the prime rate as the base rate and that its choice of the Treasury rate was not reversible error.[11] The District Court further held that the risk premium adjustment by the Bankruptcy Court was "well within the bounds of reasonableness" and was appropriate given that the Bankruptcy Court had found that no "extreme risks" existed in this case.[12] Thus, the District Court affirmed the Bankruptcy

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[7] *See, e.g.*, *In re American HomePatient*, 420 F.3d 559 (6th Cir. 2005).

[8] Ruling at 17.

[9] *Id.* at 19.

[10] *Id.* at 17-18 (citing *Valenti*, 105 F.3d at 63-64) (emphasis in original).

[11] *Id.* at 20-21.

[12] *Id.* at 21.

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Court's use of a Treasury rate plus a risk premium in the 1 to 3 percent range as appropriate to cram down secured creditors under a plan.[13]

Conclusion

The decision represents a significant risk that secured creditors must evaluate at the time a new loan is originated or purchased in the secondary market. We anticipate that more debtors will be pursuing cramdown plans to obtain the benefits afforded by long-term below-market financing that would not otherwise be available. We further anticipate that other constituents, and in particular unsecured creditors, will be supportive of such plans because they will permit those constituents to capture the difference in value created by application of the formula approach over the market approach.

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

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[13] *Id.*