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EXPERT ANALYSIS

District Court Affirms Controversial 'Cramdown' Plan in Momentive Case

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On May 4 the U.S. District Court for the Southern District of New York 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 judge's decision was controversial because it forced the debtors' senior secured creditors to accept new secured notes that generated interest at below-market rates.

The secured creditors have filed a notice of appeal to the 2nd U.S. Circuit Court of Appeals. This ruling is troubling for secured creditors — and especially those who provide financing to distressed companies — because it provides a road map Chapter 11 debtors can use to pursue reorganization plans that seek to force secured lenders to accept new secured notes at below-market rates.

As troubling as that prospect may be in a relatively low-interest-rate environment, the decision's impact will be amplified as interest rates increase. Consequently, secured creditors should re-evaluate pricing to compensate for this increased risk.[2]

FORMULA APPROACH VS. MARKET APPROACH

In the Momentive case, the debtors proposed a reorganization plan that offered a choice to its senior secured creditors. The creditors could 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. Alternatively, they could vote to reject the plan and receive new secured notes while retaining the right to litigate the allowance of the make-whole claim.

The creditors voted to reject the plan, and Judge Drain determined the lenders were not entitled to the make-whole payment. To confirm the plan over the objection of the class of secured creditors (a so-called cramdown plan), the judge 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 new notes, the judge had to determine the appropriate interest rate, also known as the discount rate.

The dispute concerned the methodology for calculating the interest rate on the new notes. There were two different approaches available: the formula approach and the market approach.

The formula approach 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 — in this case 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.[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. In that case, the note was secured by a used truck.

The market approach refers to the interest rate the debtor/borrower would be required to pay for equal financing in an efficient market.[5] In a footnote in *Till*, the Supreme Court noted that "it might make sense to ask what rate an efficient market would produce" where there is a free market of willing debtors in possession and exit lenders.[6]

In Momentive's case, 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 use 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 1/2 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%) As compared with 5% market rate	10%	4.1% (7 1/2-year Treasury plus risk premium of 2%) As compared with 7% market rate

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 the "basic principles of finance." They also posited that 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. It decided that the use of the market rate would impose "significant evidentiary costs" and aim to "make each individual creditor whole rather than to ensure the debtor's payments have the required present value." It also said the market rate would "overcompensate" creditors by covering 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 is not required in Chapter 11 cases and that the Bankruptcy Code does not require creditors to be placed "in the same position they would have been in had they arranged a new loan."[9]

The District Court noted that the 2nd 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 (1997), the 2nd Circuit "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 claimed Judge Drain erred in using the Treasury rate as the base risk-free rate, given that Supreme Court had applied the higher prime rate (then 3.25 percent) in *Till*. They argued that it was also a mistake to add an "artificial" and "arbitrary" risk premium of 1 percent to 3 percent to that base rate.

The District Court rejected these arguments, stating that *Till* did not require the Bankruptcy Court to choose the prime rate as the base rate and that its choice of the Treasury rate was not a reversible error.

The District Court further held that the Bankruptcy Court's risk premium adjustment was "well within the bounds of reasonableness" and was appropriate given that the Bankruptcy Court had found that no "extreme risks" were present.[11] Thus, the District Court affirmed the Bankruptcy Court's use of a Treasury rate plus a risk premium in the 1 to 3 percent range as an appropriate method to cram down secured creditors under a plan.

CONCLUSION

The decision illustrates a significant risk that secured creditors must evaluate when a new loan is originated or purchased in the secondary market. It is likely that more debtors will pursue cramdown plans to obtain the benefits afforded by long-term below-market financing that would not otherwise be available.

It is also likely that other constituents — particularly unsecured creditors — will support such plans because they will permit those constituents to capture the additional value created by application of the formula approach.

NOTES

1 *See U.S. Bank v. Wilmington Sav. Fund Soc'y FSB (In re MPM Silicones LLC),* No. 14-7471, 2015 WL 2330761 (S.D.N.Y. May 4, 2015).

2 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 *U.S. Bank,* 2015 WL 2330761 at *8; *see also* 11 U.S.C. § 1129(b)(2)(A)(i).

4 *U.S. Bank,* 2015 WL 2330761 at *8.

5 *Id.*

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

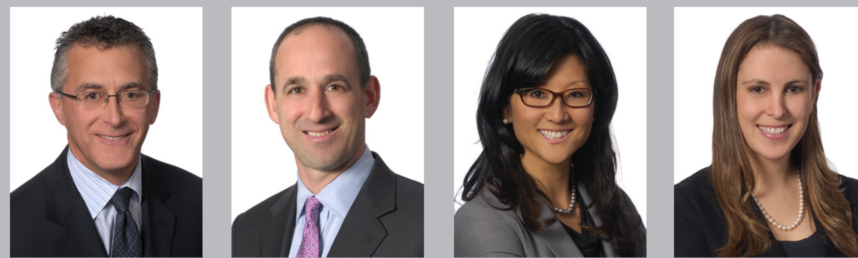
7 *See, e.g., In re Am. HomePatient,* 420 F.3d 559 (6th Cir. 2005).

8 *U.S. Bank,* 2015 WL 2330761 at *9.

9 *Id.*

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

11 *Id.* at *11.



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