Chapman Client Alert

October 30, 2017 Current Issues Relevant to Our Clients

Second Circuit Reverses MPM Silicones' "Prime Plus" Formula for Cramdown Interest Rates, Delivering Secured Creditors a Welcome Victory and Resetting Market Expectations

In a decision sure to be welcomed by secured creditors, the United States Court of Appeals for the Second Circuit reversed both the district court and the bankruptcy court's decisions in *MPM Silicones, LLC* ("*Momentive*")[1], which had held that the "prime plus" formula was the appropriate method for determining the interest rate required in connection with new notes issued to secured creditors under a Chapter 11 cramdown plan of reorganization. While the Second Circuit did not disturb the lower courts' approval of *Momentive*'s Chapter 11 plan (the "Plan"), the court strongly rejected the lower courts' determination that the Plan was "fair and equitable" despite the fact that it repaid senior secured noteholders through the distribution of replacement notes bearing interest rates far below original issue interest rates and then current market rates. Siding with the Sixth Circuit, the Second Circuit held that in determining an appropriate Chapter 11 cramdown rate, the prevailing market rate for comparable debt should be used in the presence of an efficient market for such debt and, only when no such efficient market exists, should a formula approach be used. Critically, this decision restores long-held expectations in the protections offered to secured creditors under the Bankruptcy Code.

Background

In prior client alerts regarding the lower courts' decisions in *Momentive*[2], we discussed how Judge Drain of the Bankruptcy Court for the Southern District of New York confirmed *Momentive*'s Plan, finding it "fair and equitable" despite the fact that it repaid senior secured noteholders through the distribution of replacement notes bearing interest rates far below the original issue interest rates and the current market rates for such debt. In his holding, Judge Drain determined, citing two Chapter 13 opinions (including a Supreme Court plurality opinion, *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) ("*Till*"), discussed below), that § 1129(b)(2)(A)(i)(II) of the Bankruptcy Code only requires an interest rate on deferred payments or replacement notes of "a risk free base rate" plus "a percentage, reflecting a risk factor, based on the circumstances of the estate, the nature of the collateral security and the security itself, and the duration and feasibility of the reorganization plan." Judge Drain stated that "generally speaking, that risk adjustment should be between one percent and three percent."

On appeal to the District Court for the Southern District of New York, senior noteholders argued that they were entitled to a market rate of interest on the replacement notes rather than the risk-adjusted formula rate applied by the bankruptcy court. U.S. District Judge Briccetti disagreed, siding with Judge Drain and finding that a market rate of interest would overcompensate creditors, as any market rate would necessarily include amounts related to lenders' transaction costs and profit. The court found that a market rate would therefore allow creditors to "receive more than the present rate of [their] allowed claim." Judge Briccetti found "no good reason" why interest rates on the replacement debt should place Chapter 11 creditors in the same position as they would be in if they made a new loan. Rather, Judge Briccetti held that the 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." Judge Briccetti, following Judge Drain, relied heavily on the *Till* plurality opinion, rejecting contrary authority from the Sixth Circuit (*In re American HomePatient, Inc.*, 420 F.3d 559 (6th Cir. 2005) ("*HomePatient*"), also discussed below), and two prior opinions from other courts in the Second Circuit.

The Second Circuit Reverses

Circuit Judge Parker, writing for a three-judge panel, flatly disagreed with both Judge Drain and Judge Briccetti, holding that the lower courts "erred in categorically dismissing the probative value of market rates of interest" in assessing the appropriate Chapter 11 cramdown interest rate. Rather, the Second Circuit adopted a two-part process for selecting the appropriate Chapter 11 cramdown interest rate first articulated by the Sixth Circuit in *HomePatient*, holding that "the market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach endorsed by the *Till* plurality." The Second Circuit remanded "so that the bankruptcy court can ascertain if an efficient market rate exists and, if so, apply that rate, instead of the formula rate."

In discussing the court's reasoning, Judge Parker noted that at issue in *Till* was a Chapter 13 debtor's sub-prime auto loan, carrying an interest rate of 21%, for which there was no efficient market. He explained that while the *Till* plurality suggested that the "formula" method adopted in that case might be applicable to cramdown interest rate calculations made in other "similarly worded" Bankruptcy Code provisions (like those applicable to cramdown in Chapter 11), the plurality "made no conclusive statement as to whether the 'formula' rate was generally required in Chapter 11 cases." Judge Parker then cited *Till*'s "much-discussed footnote 14," which stated that "when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce," whereas in Chapter 13 cramdowns "there is no free market of willing cramdown lenders."

The court concluded that "[we] do not read the *Till* plurality as stating that efficient market rates are irrelevant in determining value in the Chapter 11 cramdown context. And, disregarding available efficient market rates would be a major departure from long-standing precedent dictating that the best way to determine value is exposure to a market. . . [W]here, as here, an efficient market may exist that generates an interest rate that is apparently acceptable to sophisticated parties dealing at arms-length, we conclude, consistent with footnote 14 [of *Till*], that such a rate is preferable to a formula improvised by a court."

In so holding, the court rejected Judge Drain and Judge Briccetti's concerns that a market rate of interest would "overcompensate" cramdown lenders with "imbedded profit," finding that when cramdown notes are priced according to a prevailing efficient market, lenders are compensated only for the risk they bear by holding the cramdown notes.

Equitable Mootness

We note briefly that in reaching a determination on the Chapter 11 cramdown interest rate question addressed in this client alert, and on unrelated make-whole questions raised by the *Momentive* case on appeal[3], the Second Circuit first had to decide that determination of such questions was not equitably moot by the earlier confirmation of *Momentive*'s Plan.

The court explained that "[w]here, as here, a reorganization plan has been substantially consummated, we presume that an appeal of that plan is equitably moot . . . That presumption, however, gives way where five factors are met. They are, where: (i) effective relief can be ordered; (ii) relief will not affect the debtor's re-emergence; (iii) relief will not unravel intricate transactions; (iv) affected third-parties are notified and able to participate in the appeal; and (v) appellant diligently sought a stay of the reorganization plan."

The court went on to explain that although satisfaction of each such factor is necessary to overcome a mootness presumption, special weight should be placed on the fifth factor, noting that "if a stay was sought, we will provide relief if it is at all feasible, that is, unless relief would knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the Bankruptcy Court." Here, the court found that appellants immediately objected to various parts of the Plan, sought stays in three different courts, otherwise behaved with all due diligence and that its ruling in these cases would be unlikely to create any sort of unmanageable, uncontrollable situation requiring application of equitable mootness.

Conclusion

The Second Circuit's opinion is an unqualified win for secured creditors on the cramdown interest rate issue. When Judge Briccetti affirmed the bankruptcy court's Momentive decision, there was concern that the decision would serve to embolden debtors by increasing their power to threaten secured creditors with payment through replacement notes, with extended maturities and at reduced rates, which could have meaningfully increased the cost of secured credit. This decision mitigates those concerns and restores long-held expectations in the secured credit market and the protections afforded to secured creditors under the Bankruptcy Code. Better still, this decision significantly reduces uncertainty around the application of *Till*'s formula rate to Chapter 11 cramdown notes in the Second Circuit, reducing the risk of forum-shopping for Chapter 11 debtors party to loan agreements bearing relatively high interest rates.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

Michael Friedman
New York
212.655.2508
friedman@chapman.com

Larry G. Halperin
New York
212.655.2517
halperin@chapman.com

Aaron M. Krieger
Chicago
312.845.3487
akrieger@chapman.com

1 *In re MPM Silicones (Momentive), LLC*, 2017 WL 4700314 (2d Cir. Oct. 20, 2017).

2 See MPM Silicones Latest Court to Whittle Away at Secured Creditor Protections: Plan Confirmed Providing Secured Creditors with Below Market Replacement Notes (September 29, 2014); S.D.N.Y Affirms MPM Silicones' "Prime Plus" Formula for Cramdown Interest Rates, Likely Harming Creditor Recoveries (May 18, 2015); Is Momentive Losing Momentum? (November 22, 2016).

3 See Momentive vs EFIH: Second Circuit Splits with Third Circuit on Make-Whole; Keeps Pressure on Lenders to Negotiate Express Make-Whole Provisions (October 30, 2017).

Chapman and Cutler LLP

Attorneys at Law · Focused on Finance®