CRAVATH, SWAINE & MOORE LLP

Paul H. Zumbro
+1-212-474-1036
pzumbro@cravath.com

George E. Zobitz
+1-212-474-1996
jzobitz@cravath.com

Omid H. Nasab
+1-212-474-1972
onasab@cravath.com

Andrew J. Pitts
+1-212-474-1620
apitts@cravath.com

Till No More: Second Circuit in *Momentive* Requires Market Interest Rate for Secured Creditor Cramdown in Chapter 11

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On October 20, 2017, the Second Circuit (the "Court") issued its long-awaited opinion on the appeals of the plan confirmation order in the Momentive Performance Materials Inc. ("MPM") bankruptcy case. The decision covers several issues important to creditors at all levels of the capital structure, with particular importance for secured creditors. The key issues addressed in the opinion include:

- lien subordination versus payment (or debt) subordination;
- entitlement to "make-whole" premiums in bankruptcy; and
- whether the interest rate on replacement notes issued in a Chapter 11 cramdown should be market-based or formula-based.

In an important victory for secured creditors, the Court rejected the formula-based approach (which typically results, and in the *MPM* case did result, in a below market rate of interest on replacement notes) in favor of a market rate of interest where an efficient market rate can be ascertained. Because a market rate should generally be ascertainable in Chapter 11 cases (particularly in large cases like *MPM*), this holding should significantly reduce the likelihood that secured creditors will be forced to take back replacement debt with a below market coupon in a Chapter 11 reorganization.

BACKGROUND

MPM faced serious financial problems after it took on significant new debt obligations beginning in the mid-2000s. The three relevant classes of notes issued by MPM were: (1) Subordinated Notes; (2) Second-Lien Notes; and (3) Senior-Lien Notes (first and 1.5 lien), which included a "make-whole" premium if MPM opted to redeem the notes prior to maturity.

Following these debt issuances, MPM was substantially overleveraged, and filed a petition under Chapter 11 on April 14, 2014. MPM proposed a plan of reorganization which provided for (i) a 100% cash recovery of the principal balance and accrued interest on the Senior-Lien Notes; (ii) an estimated 12.8%-28.1% recovery on the Second-Lien Notes in the form of equity in the reorganized debtors; and (iii) no recovery on the Subordinated Notes. The plan also gave the Senior-Lien Notes holders the option of (i) accepting the plan and immediately receiving a cash payment of the outstanding principal and interest due on their notes (without a make-whole premium), or (ii) rejecting the plan, receiving replacement notes with a present value equal to the allowed amount of such holder's claim, and then litigating in the bankruptcy court whether they were entitled to the make-whole premium and whether the interest rate on the replacement notes was fair and equitable.

The Subordinated Notes holders and the Senior-Lien Notes holders opposed the plan. The Subordinated Notes holders contended that, under the relevant indenture provisions, their notes were not subordinate to the Second-Lien Notes holders and, consequently, they were entitled to some recovery. The Senior-Lien Notes holders opposed the plan on the ground that the replacement notes they received did not provide for the make-whole premium, and carried an interest rate that was well below ascertainable market rates for similar debt obligations and thus was not fair and equitable, a requirement under the Bankruptcy Code for a cramdown, because it failed to give them the present value of their claim.

Despite these objections, the bankruptcy court confirmed the plan and the district court affirmed.

LIEN SUBORDINATION VERSUS PAYMENT (OR DEBT) SUBORDINATION

The first issue the Court addressed was the Subordinated Notes holders' challenge to the lower courts' conclusions that their claims were subordinate to the Second-Lien Notes holders' claims. The Court came to the same conclusion as the lower courts—that the Second-Lien Notes are "Senior Indebtedness" under the Subordinated Notes indenture and thus entitled to payment priority over the Subordinated Notes—but did so only after concluding that the indenture was ambiguous as a matter of law. This required the Court to go through a detailed analysis of extrinsic evidence (e.g., bond offering memorandum disclosure (including risk factor disclosure), SEC filings and other public statements) and the likely intent of the parties before concluding that the Second-Lien Notes were entitled to priority.

For both investors and issuers, it would clearly be preferable if a term as important as "Senior Indebtedness"[1] in a subordinated notes indenture were drafted in an unambiguous manner. In *MPM*, the potential ambiguity arose from the fact that the general definition of Senior Indebtedness excludes debt that is subordinate "*in right of payment*" to any other indebtedness of the issuer, whereas the Fourth Proviso to the definition excludes (seemingly more broadly) debt that is subordinate or junior "*in any respect*" to any other indebtedness of the issuer. The Court first noted that it was undisputed that the Second-Lien Notes are not subordinated in right of payment to any other indebtedness and thereby met the baseline definition of "Senior Indebtedness". The question the Court then addressed was whether liens that are junior to the liens securing another series of debt (here, the Second-Lien Notes with liens junior to the Senior-Lien Notes) make the junior lien debt subordinate "in any respect" to other indebtedness and thereby excluded from the definition of "Senior Indebtedness" by virtue of the Fourth Proviso and, accordingly, not entitled to the benefit of payment subordination of the Subordinated Notes.

In addressing the appropriate interpretation of the Fourth Proviso, the Court noted that "as a practical matter, it seems to us to be illogical to believe that a second-lien holder does not possess an obligation that is meaningfully subordinate in some respect to a first-lien holder." However, the Court went on to conclude that an expansive reading of the Fourth Proviso to cover lien subordination would have the effect of rendering the "in right of payment" language in the baseline definition superfluous. Unlike the lower courts, the Court concluded that the definition of "Senior Indebtedness" was ambiguous and that it was therefore appropriate to look to extrinsic evidence to determine the intent of the parties.

In resolving the ambiguity, the Court gave weight to the following extrinsic evidence:

- MPM's clear and consistent public disclosure that the Second-Lien Notes were senior in right of payment to all subordinated indebtedness;
- the fact that *unsecured* debt would have greater effective priority than secured debt if lien subordination disqualified the Second-Lien Notes from constituting "Senior Indebtedness"; and
- the fact that a broad reading of "in any respect" to cover lien subordination would have disqualified even the Senior-Lien Notes from constituting "Senior Indebtedness" because the Senior-Lien Notes had a second priority lien on certain collateral securing MPM's revolving credit facility.

Based on its interpretation of the extrinsic evidence, the Court ultimately concluded that the Second-Lien Notes constituted "Senior Indebtedness" despite the Fourth Proviso and thus had priority relative to the Subordinated Notes.

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[1] Under a subordinated notes indenture, the subordinated notes are subordinated in right of payment to all indebtedness of the issuer that constitutes "Senior Indebtedness". "Senior Indebtedness" is in turn typically defined as all indebtedness of the issuer unless the instrument creating the indebtedness expressly provides that such obligations are subordinated *in right of payment* to any other indebtedness of the issuer, with the further provisos that Senior Indebtedness does not include (1) intercompany debt, (2) liabilities for taxes, (3) ordinary course obligations to trade creditors, (4) any debt that by its terms is subordinate or junior in any respect to any other debt of the issuer, (5) equity interests and (6) debt incurred in violation of the subordinated notes indenture. The carve-out in (4) (what the Second Circuit refers to as the "Fourth Proviso") was at issue in *MPM* and what the Court found to result in an ambiguity.

MAKE-WHOLE PREMIUM IN BANKRUPTCY

The indentures governing the Senior-Lien Notes contain optional redemption clauses, which provide for the payment of a make-whole premium (a premium to compensate for lost interest if notes are redeemed early) if MPM were to "redeem the Notes at its option" prior to the stated maturity date of October 15, 2015. The Court concluded that the Senior-Lien Notes holders were not entitled to a make-whole premium in connection with receiving replacement notes under the MPM plan of reorganization.

The Court reasoned as follows:

- filing for bankruptcy automatically accelerates the debt;
- acceleration brought about by a bankruptcy filing changes the date of maturity of the accelerated notes to the date of the bankruptcy petition;
- therefore, any payment on the accelerated notes following a bankruptcy filing would be a *post*-maturity payment; and
- a post-maturity payment is mandatory, not an optional (early) redemption.

The Court rejected the Senior-Lien Notes holders' argument that they were entitled to the make-whole premium because when MPM issued the replacement notes under the MPM plan, it "redeemed" the Senior-Lien Notes "at its option" prior to maturity. It also rejected the Senior-Lien Notes holders' argument that they could have waived the acceleration, holding that such a waiver would violate the automatic stay.

The market has been eagerly awaiting the Court's decision on the make-whole premium issue following the Third Circuit's *EFH* decision from November 16, 2016. *In re Energy Future Holdings Corp.*, 842 F.3d 247, 251 (3rd Cir. 2016). The bankruptcy court in the *Energy Future Holdings* case held that the make-whole was not payable in that case, and the district court affirmed. EFH formulated a plan of reorganization predicated on the make-whole not being payable. However, the Third Circuit reversed and held that Energy Future must pay the make-whole.

While on their face *EFH* and *MPM* seem to be in conflict—one case found that a make-whole premium was payable in bankruptcy and the other case found it was not—we believe that the specific facts of each case drove the different outcomes. In *EFH*, Energy Future was solvent at the time it effected the refinancings and Energy Future effected the refinancings *during the course* of its bankruptcy case in a cash transaction to take advantage of a lower interest rate environment. MPM, on the other hand, simply issued replacement notes *at the end* of its bankruptcy case pursuant to a confirmed plan of reorganization, an outcome specifically contemplated by the Bankruptcy Code.[2] Thus, a potential way that courts may reconcile the two decisions going forward is to deem make-whole premiums not payable when notes are addressed through a plan of reorganization, but deem them payable when notes are redeemed during a bankruptcy case by a solvent debtor (i.e., outside the Bankruptcy Code framework versus within it). How the bankruptcy courts in fact reconcile these two decisions going forward will be keenly followed by market participants.

CRAMDOWN INTEREST RATE

Perhaps the most important part of the Court's *MPM* decision—particularly from the perspective of secured creditors—is its rejection of a formula-based approach to determining the appropriate rate of interest under the cramdown provisions of Chapter 11 in favor of a market-based approach. The importance of this decision can hardly be overstated, as the risk of being crammed down with take-back paper with a below market rate of interest has been something of a Sword of Damocles hanging over the heads of secured creditors ever since the Supreme Court's 2004 decision in *Till*.[3]

As a consequence of rejecting the MPM plan, the Senior-Lien Notes holders received replacement notes which pay out their claim over time. The Bankruptcy Code permits debtors to make such "deferred cash payments" to secured

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2 The Third Circuit in *EFH* seems also to have been influenced by Energy Future's seemingly tactical use of the bankruptcy process to avoid having to pay the make-whole premium, noting that refinancing the notes outside of bankruptcy would have required Energy Future to pay the make-whole premium and that "[b]y filing for bankruptcy, however, EFIH believed it might avoid the premium. So on November 1, 2013, it filed an 8-K form with the Securities and Exchange Commission 'disclosing [its] proposal [whereby] . . . EFIH would file for bankruptcy and refinance the [n]otes without paying the make-whole amount." *EFH* (quoting In re Energy Future Holdings Corp., 547 B.R. 178, 188 (Bankr. D. Del. 2015)) (internal quotation marks omitted).

3 *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

creditors (i.e., to "cramdown").[4] Such payments must be at least equal to the full value of the secured creditors' claims.[5] To ensure the creditor receives the full present value of its secured claim, the deferred payments must carry an appropriate rate of interest. The key question is what that rate is, as it has a direct economic impact on the creditors forced to take back paper under a Chapter 11 plan, such as MPM's creditors.

The issue of what is the appropriate rate of interest in the context of a Chapter 11 cramdown plan has been unclear for many years, following the Supreme Court's 2004 decision in *Till*. At issue in *Till* was a Chapter 13[6] debtor's sub-prime auto loan, carrying an interest rate of 21% and providing the creditor with a $4,000 secured claim. The *Till* court rejected a market-based approach to determining the appropriate interest rate in the context of a secured creditor cramdown, in part because in Chapter 13 cramdowns "there is no free market of willing cramdown lenders".[7] Instead, the Supreme Court endorsed a "formula-based" approach that starts with a largely risk-free interest rate (the prime rate) and then leaves it up to the bankruptcy court to determine an appropriate plan-specific risk adjustment to that prime rate.

Ignoring the market rate and instead relying on a bankruptcy judge to make the determination of the appropriate rate of interest is contrary to the general principle in bankruptcy that the market is the best source of valuation. The Supreme Court in *Till* did leave open the possibility of a market-based approach in the context of a Chapter 11 cramdown, but it was in a rather Delphic footnote and many judges—including both the bankruptcy and the district court judges in *MPM*—felt bound by *Till* to dismiss market rates of interest in favor of the formula-based approach. The *MPM* decision is the first time the Second Circuit has addressed this question in the 13 years since *Till* was decided.

In *MPM*, the Second Circuit stated that "where, 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 . . . that such rate is preferable to a formula improvised by a court." Having determined that exit financing was available to MPM, and that the rates quoted by potential exit finance providers were significantly higher than the formula-based approach imposed by the bankruptcy court, 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.

CONCLUSION

The Second Circuit's decision in *MPM* meaningfully reduces the likelihood of secured creditors being crammed down with paper that bears a below market interest rate. Confirmation that lien subordination does not equate to payment subordination for purposes of a subordinated notes indenture was also a helpful clarification. We suspect that make-whole premiums in bankruptcy will continue to generate significant litigation unless and until the issue is addressed by the Supreme Court.

New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

www.cravath.com

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4 11 U.S.C. § 1129(b)(2)(A)(i)(II).

5 *Id.*

6 Chapter 13 allows individuals with regular income to restructure their debts under a payment plan.

7 541 U.S. at 476 n.14.