Bankruptcy Court Holds That Secured Creditors Can Be "Crammed Down" With Below-Market Rate Replacement Notes

On August 26, 2014, in the case *In re MPM Silicones, LLC*, Case No. 14-22503 (Bankr. S.D.N.Y.) ("*Momentive*"), the United States Bankruptcy Court for the Southern District of New York held that secured creditors could be "crammed down" in a chapter 11 plan with replacement notes bearing interest at substantially below market rates. Unless overturned on appeal, this decision will introduce a new level of risk to leveraged lending – secured lenders will face the specter of losing in a bankruptcy restructuring not only their negotiated rates, but any semblance of market treatment. This risk could result in a tightening of availability and increased costs to borrowers in levered transactions.

One of the primary issues at plan confirmation in *Momentive* was whether the Debtors had satisfied the Bankruptcy Code requirements for "cram down" of a plan of reorganization on dissenting secured creditors. Among various conditions, the Bankruptcy Code permits a debtor to confirm a plan of reorganization over the objection of a class of secured creditors if the holders of the secured claims (i) retain the liens securing their claims, and (ii) receive deferred cash payments with a "present value" on the plan's effective date equal to the amount of their secured claims. Bankruptcy Judge Robert D. Drain's bench ruling addressed whether the replacement notes to be issued to the secured bondholders under the *Momentive*chapter 11 plan offered a satisfactory cramdown interest rate.

In 2012, Momentive Performance Materials ("MPM") issued $1.1 billion of 8.875% first priority senior secured notes due 2020 (the "First Lien Notes") and $250 million of 10% senior secured notes due 2020 (the "1.5 Lien Notes"). MPM and its affiliated debtors filed for chapter 11 in April, 2014, and shortly thereafter filed declaratory judgment actions challenging the entitlement of the noteholders to over $200 million in claims for make-whole premiums. The Debtors' proposed chapter 11 plan provided that, if a class of secured creditors voted in favor of the plan, the noteholders in such class would receive a cash distribution equal to their claims for principal and interest but would waive any claims for make-whole premiums. If a class accepted the plan, the Debtors proposed to fund the cash distribution with the proceeds of exit financing commitments obtained through a competitive marketing process. The committed exit financing had minimum effective interest rates of approximately 5% for long-term refinancing of the First Lien Notes and approximately 7% for temporary bridge financing of the 1.5 Lien Notes. If, on the other hand, a secured creditor class rejected the plan, the class's entitlement to the make-whole premiums would be litigated and the noteholders would receive replacement notes, including amounts in respect of any allowed make-whole claims, bearing interest at the applicable Treasury rate plus a modest risk premium: T+150 (approx. 3.6%) for the First Lien Notes and T+200 (approx. 4.1%) for the 1.5 Lien Notes.

Both secured creditor classes rejected the plan, and the Bankruptcy Court held a multi-day trial to determine, among other things, the holders' entitlements to the make-whole premiums and whether the proposed replacement notes satisfied the Bankruptcy Code's cramdown requirements.

The Debtors argued that their proposed plan satisfied the cramdown guidelines as applied by the United States Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). In *Till*, the Supreme Court addressed the interest rate to be applied to deferred cash payments being distributed to a dissenting secured creditor under a chapter 13 plan, concluding that that the proper interest rate should be determined applying a formula approach, which takes a base rate, such as the prime rate, and increases it to account for risk of nonpayment. The Supreme Court referenced a Second Circuit decision in a chapter 13 case that suggested the risk premium should range between 1% and 3%.

The indenture trustees for the dissenting noteholders argued that in *Till* the Supreme Court applied a formula approach only because the Court was considering a chapter 13 plan in which the proper market rate could not be fairly and conveniently identified. In a chapter 11 case, such as *Momentive*, where the market rate was readily identifiable, the trustees argued that the market rate should apply – citing in support a footnote in the *Till* opinion. They noted that the market rate of interest in *Momentive* was clearly and conveniently evidenced by the exit financing commitments.

The Bankruptcy Court rejected the trustees' argument and opined that *Till* generally "does not require that creditors be made subjectively indifferent between present foreclosure and future payment . . . ." The Bankruptcy Court held that *Till* instead requires that the cramdown interest rate be based solely on a base rate plus a risk factor, and such rate must exclude any component of profit that would be obtained in a market-based rate, such as the committed exit financing the Debtors had obtained.

Although the Bankruptcy Court accepted the concept of using a formula method to determine the proper interest rate for replacement notes in a cramdown, the court denied confirmation of the *Momentive* plan, finding that, even applying the formula approach, the rates proposed by the Debtors were slightly too low. The Bankruptcy Court advised that the plan would be confirmable if the rates were adjusted upward by 0.5% for the First Lien Notes and 0.75% for the 1.5 Lien Notes. It is widely expected that the Debtors will amend the plan to provide for this additional interest, which remains well below market rates.

Market participants will certainly watch to see whether the *Momentive* decision is appealed, and, if it is, the outcome of such appeal. Lenders should recognize that the decision of a bankruptcy court, though potentially influential, is technically not binding on any other courts, even within the same district. Nevertheless, lenders should consider the risk highlighted by the*Momentive* decision, and whether to change loan structures to address this risk.

For example, senior secured lenders may use inter-creditor arrangements to shift this risk to junior lenders and/or attempt to address the risk through make-whole provisions that adequately compensate lenders for the lost returns in the context of a chapter 11 cramdown at below-market rates. These solutions, of course, are not helpful if there is only unsecured debt below the senior secured debt, or if the secured loan is of a nature that make-whole provisions are inappropriate.

As parties contemplate drafting around this issue, it is helpful to observe that, although the*Momentive* bankruptcy court denied the make-whole premium sought by the indenture trustees in this case, the court recognized that a make whole would be enforceable in chapter 11 if the indenture language had been drafted differently.

Mark I. Bane
Alyson Allen
Alfred O. Rose
Stephen Moeller-Sally
David C. Djaha