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Memorandum

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S.D.N.Y. Bankruptcy Court Denies Claim for Make-Whole Premium and Allows Cram Down of Debtors' Chapter 11 Plan Paying Secured Creditors Below-Market Interest Rates on Replacement Notes

On August 26, 2014, the Honorable Robert D. Drain, Bankruptcy Judge of the United States Bankruptcy Court for the Southern District of New York, issued several bench rulings (the "Bench Rulings") in connection with confirmation of a plan of reorganization in the chapter 11 cases of *MPM Silicones, LLC, et al.* (the "Debtors").[1] Notably, Judge Drain determined that (i) the First Lien Noteholders and the 1.5 Lien Noteholders (collectively, the "Senior Lenders") were not entitled to a make-whole premium as a result of the automatic acceleration of their notes caused by the bankruptcy filing and (ii) the Debtors may satisfy the cramdown requirements of the Bankruptcy Code by distributing to the Senior Lenders, under the Debtors' plan of reorganization (the "Plan"), replacement notes in the face amount of their allowed claims with interest rates that reflect only the repayment risk rather than market rates.

Judge Drain held that the replacement notes for the Senior Lenders should include an interest rate comprised of a risk-free base rate of approximately 2.1%, which Judge Drain noted was the relevant U.S. Treasury rate on the date of the Bench Rulings, plus a premium based on the repayment risk of 2.00% for First Lien Noteholders and 2.75% for 1.5 Lien Noteholders, for a total interest rate of approximately 4.1% and 4.85%, respectively. Judge Drain indicated that he would confirm an amended plan that complies with this interest rate formula. Since the Bench Rulings, the Senior Lenders filed motions to allow them to change their rejection votes to now accept the Plan, which would entitle the Senior Lenders to receive payment of their allowed claims in full in cash rather than replacement notes.

Background

With respect to the Senior Lenders' distributions, the Plan included a toggle provision, which provided for payment in full in cash, but without a make-whole premium, if the Senior Lenders' classes voted to accept the Plan. In the alternative, if the classes voted to reject the Plan, the First Lien Noteholders would receive seven-year replacement notes with an interest rate equal to the Treasury rate plus a risk premium of 1.5%, and the 1.5 Lien Noteholders would receive seven-and-a-half-year replacement notes with an interest rate equal to the Treasury rate plus a risk premium of 2.0%.

The Senior Lenders overwhelmingly voted to reject the Plan and pursued payment of the make-whole premium they argued they were owed. After the confirmation hearing, but before Judge Drain issued his ruling, the Senior Lenders requested permission to change their votes on the Plan, which would concede

[1] *In re MPM Silicones, LLC, et al.*, Case No. 14-22503-RDD (Bankr. S.D.N.Y. Aug. 26, 2014) (Transcript).

the make-whole premium argument but allow for payment in cash rather than replacement notes with below-market interest rates. The Debtors opposed this last-minute attempt to change course. Judge Drain directed the parties to negotiate for a day to see if they could reach a settlement. The next day, however, no settlement was reached, and Judge Drain issued the Bench Rulings on the confirmation issues and scheduled a hearing for a later date with respect to the Senior Lenders' motions to change their votes.

Make-Whole Premium

The Senior Lenders argued that they were entitled to a make-whole premium based on the automatic acceleration of their debt as a result of the Debtors' bankruptcy filing.

Judge Drain held that the Senior Lenders were not entitled to a make-whole premium in this case because "absent specificity, which is here lacking, the firsts and 1.5 indentures do not create an enforceable claim for the applicable premium following acceleration automatically of the debt."[2] Judge Drain explained that the purpose of the make-whole premium is to ensure that the lenders get compensated for the interest they will not receive because they were paid early.[3] On the other hand, Judge Drain noted that it is well established that under New York law a lender loses the right to consideration for early payment by accelerating the balance of the loan. Judge Drain further explained that "rather than being compensated for its desire to be paid interest over the life of the loan, the lender has accelerated choosing instead to be paid early, thus obviating the right to such compensation for not having received interest payments during the life of the loan."[4] Judge Drain reasoned that by agreeing to the automatic acceleration provision in the loan documents, the Senior Lenders forfeited their right to the make-whole premium based on the Debtors' bankruptcy filing.[5] Judge Drain explained that parties can contract around this with clear and unambiguous language that provides for payment of a make-whole premium even in the event of automatic acceleration due to a bankruptcy filing, but noted that this clear and unambiguous language was lacking in the indentures.[6]

Judge Drain also addressed the Senior Lenders' argument that the indentures included a no-call provision that states, "Except as set forth in the following two paragraphs the note shall not be redeemable," which the Debtors will breach by repaying the notes.[7] Judge Drain noted that this provision "is not a specific contractual noncall provision, but rather simply the lead-in to say [that the Senior Lenders] have [the] option [to redeem in return for payment of the applicable premium]."[8] Judge Drain further noted that under New York law there would be damages for such a claim, but explained that under section 502(b)(2) of the Bankruptcy Code such a claim would be disallowed as a claim for unmatured interest.[9]

In the alternative, the Senior Lenders requested that the automatic stay be lifted so that they could deliver a notice rescinding the automatic acceleration of their notes. Judge Drain explained that the purpose of sending the rescission notice would be to "resurrect the make-whole claim" and noted that the Second Circuit recently held, in a very similar context, that sending such a notice would, in fact be subject to the automatic stay.[10] Moreover, Judge Drain stated that sending such a rescission notice would have "important material consequences for the estate and its creditors … [and] is the type of action that courts

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2 *Id.* at 38:10-13.

3 *Id.* at 41:4-8.

4 *Id.* at 35:12-22.

5 *Id.* at 37:23-25.

6 *Id.* at 36:9-11.

7 *Id.* at 32:13-14.

8 *Id.* at 45:8-10.

9 *Id.* at 46:2-8.

10 *Id.* at 51:23; 52:1-3 (citing *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013).

have routinely refused to permit."[11] Accordingly, Judge Drain held that the automatic stay should not be lifted to allow the Senior Lenders to rescind the automatic acceleration.[12]

Interest Rate on Replacement Notes

Because the Senior Lenders' classes voted to reject the Plan, the Debtors are required to satisfy the cramdown requirements of section 1129(b)(2) of the Bankruptcy Code, which includes the requirement that the plan be "fair and equitable." Specifically, with respect to a non-accepting class of secured claims, which includes the Senior Lenders, the Plan is fair and equitable if it provides that these secured creditors retain the liens securing their claims and that each secured creditor receive deferred cash payments with a present value at least equal to the allowed amount of such claim.

Based primarily on the Supreme Court's plurality opinion in *Till v. SCS Credit Corp.*[13] and the Second Circuit's decision in *In re Valenti*,[14] Judge Drain held that the present value test in section 1129(b)(2)(A)(i)(II) is satisfied with an interest rate of a risk-free base rate plus a risk premium that reflects only the repayment risk associated with the Debtors (i.e., the interest rate need not include any profits, costs or fees). Judge Drain stated that "as a first principle, the cramdown interest rate, under Section 1129(b)(2)(A)(i)(II), should not contain any profit or cost element" because to include profit or costs would be "inconsistent with the present-value approach for cramdown purposes."[15] Judge Drain's approach could provide the Senior Lenders with new notes that have a market value of less than 100% of the allowed amounts of the Senior Lenders' claims.

Judge Drain acknowledged that *Till* and *Valenti* involved chapter 13 of the Bankruptcy Code rather than chapter 11, but explained that section 1325(a)(5)(B)(ii) is closely analogous.[16] In further support, Judge Drain noted that the Supreme Court stated that "Congress likely intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of the many Code provisions requiring a court to discount a stream of deferred payments back to their present dollar value."[17]

Judge Drain addressed the argument that a market rate should be applied to the replacement notes by explaining that the Supreme Court already rejected the market rate approach. Specifically, Judge Drain quoted the Supreme Court as follows:

> These considerations … lead us to reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors -- an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court supervised cramdown loans.[18]

Notwithstanding the Supreme Court's opinion in *Till*, some courts have held that in chapter 11 cases a formula rate, similar to the one adopted by Judge Drain, applies only if there is not an efficient market

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[11] *Id.* at 59:23-25; 60:1-2.

[12] *Id.* at 61:15-20.

[13] *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

[14] *In re: Valenti*, 105 F.3d 55 (2d Cir. 1997).

[15] *In re MPM Silicones, LLC, et al.*, Case No. 14-22503-rdd, at 67:18-22 (Bankr. S.D.N.Y. Aug. 26, 2014) (Transcript).

[16] *Id.* at 64:16-19.

[17] *Id.* at 65:3-7 (citing *Till*, 541 U.S. at 466).

[18] *Id.* at 66:3-19 (quoting *Till*, 541 U.S. at 477).

from which a market rate can be determined.[19] Judge Drain noted that these courts rely almost entirely on footnote 14 of the *Till* opinion, which, in essence, states that there is no free market of willing cramdown lenders in chapter 13, but there are numerous DIP lenders in chapter 11. Judge Drain, however, explained that DIP loans voluntarily made by creditors and cramdown loans forced on unwilling creditors are completely different. In support, Judge Drain quoted a similar criticism of *Till's* footnote 14 found in *Collier on Bankruptcy*, which states that "the relevant market for involuntary loans in Chapter 11 may be just as illusory as in Chapter 13."[20] Moreover, Judge Drain noted that no private lender would lend without building in costs, fees and profit, which should not be included in the analysis when determining the present value of deferred cash payments for cramdown purposes.[21] In rejecting the market rate approach to determining the present value of future payments for cramdown purposes, Judge Drain also indicated that an efficient market rate, if it exists, would presumably result from a profit element and, therefore, would be higher than the repayment risk formula used by the Supreme Court in *Till.*

Judge Drain stated that his interest rate formula is in line with the Supreme Court's and the Second Circuit's approach, "which is to have a risk-free base rate which would then be increased by 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."[22] Further, Judge Drain explained that the U.S. Treasury note rate, rather than the prime rate, is an "appropriate base rate for longer-term debt" because "the Treasury rate, by its very definition, in addition to not including a profit, also does not include any risk, given that it's the United States government that is the obligor."[23] Finally, Judge Drain concluded that the replacement notes interest rates in this case should be increased slightly above the rates set forth in the Plan -- by 0.5% points for the First Lien Notes and 0.75% points for the 1.5 Lien Notes -- so that they equal the seven-year Treasury rate plus 2.00% and the imputed seven-and-a-half-year Treasury rate plus 2.75%, respectively, to reflect the increased risk of nonpayment.[24]

Conclusion

Judge Drain's make-whole decision serves as an important reminder that specific and unambiguous language is necessary to obtain a make-whole premium in the event the debt is automatically accelerated by a bankruptcy filing.

The full ramifications of Judge Drain's decision allowing a chapter 11 debtor to compel classes of unwilling secured creditors to receive in full satisfaction of their claims replacement notes with below-market interest rates remains to be seen. If Judge Drain grants the Senior Lenders' motions to allow them to change their votes to accept the Plan so that they receive on the effective date of the Plan cash equal to the allowed amount of their claims, instead of being compelled to receive the replacement notes, any appeal on the interest rate issue would be moot. If the Senior Lenders, however, are not permitted to change their votes, this issue may yet be decided by an appellate court. If Judge Drain's decision stands, it is possible that in the future (i) debtors will use the threat of payment in the form of below-market replacement notes as leverage in the dynamics of negotiating consensual plans of reorganization and (ii) secured lenders will increase interest rates generally to account for the risk of being paid in below-market replacement notes in the event of bankruptcy.

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[19] See e.g., *In re American Homepatient, Inc.*, 420 F.3d 559 (6th Cir. 2005); *Mercury Capital Corp. v. Milford Connecticut Associates, L.P.*, 354 B.R. 1 (D. Conn. 2006); *In re 20 Bayard Views LLC*, 445 B.R. 83 (Bankr. E.D.N.Y. 2011).

[20] *In re MPM Silicones, LLC, et al.*, at 70:24-25 (quoting 3 COLLIER ON BANKRUPTCY CH 1129.05 (Alan N. Resnick & Henry J. Sommers eds., 16th ed.)).

[21] *Id.* at 76:1-3.

[22] *Id.* at 68:5-10 (citing *Till*, 541 U.S. at 479; *Valenti*, 105 F3d at 64).

[23] *Id.* at 82:19-20; 83:3-6.

[24] *Id.* at 83:12-25; 84:1-10.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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