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Second Circuit Clarifies Interest Rate Applicable in Chapter 11 "Cramdowns"

On October 20, 2017, in *In re MPM Silicones, LLC* ("Momentive"), Nos. 15-1682, 15-1771, 15-1824, the Second Circuit Court of Appeals, considering the Supreme Court's opinion in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), adopted the Sixth Circuit's two-step approach to determining an appropriate cramdown interest rate that, in certain circumstances, results in the application of a market rate of interest. In doing so, the Second Circuit reversed the bankruptcy and district court holdings on the cramdown interest rate issue. However, the Second Circuit upheld the bankruptcy and district court holdings denying certain bondholders the benefit of contractual "make-whole" provisions, as well as the lower courts' findings with respect to the subordination of certain debt obligations. The Second Circuit also agreed with the district court that, notwithstanding the substantial consummation of the Debtors' Plan, the appeals were not equitably moot. The two key takeaways from the Second Circuit's decision are (i) secured creditors gained protection from below-market cramdown interest rates by requiring application of the so-called "market rate" approach; and (ii) the circuit split between the Second and Third Circuits regarding the availability of make-whole relief following an issuer's bankruptcy filing may affect venue decisions for distressed issuers going forward.

Overview of the Case and the Decisions of the Lower Courts

Silicone producer MPM Silicones, LLC ("MPM") filed a petition for Chapter 11 in April 2014, in an attempt to restructure its highly overleveraged balance sheet. MPM had issued four classes of notes relevant to the immediate appeal: Subordinated Notes; Second Lien Notes; and Senior Lien Notes (including the First Lien Notes and 1.5-Lien Notes). The bankruptcy court approved a plan of reorganization (the Plan), providing for, among other things: (i) a 100 percent cash recovery of the principal balance and accrued interest on the Senior Lien Notes; (ii) a 12.8-28.1 percent recovery by the Second Lien Notes in the form of equity in the reorganized company; and (iii) no recovery on the Subordinated Notes.

The Plan was facilitated by Chapter 11's "cramdown" provision, which allows bankruptcy courts to confirm reorganization plans over the objections of certain creditors if the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1). In such circumstances, debtors are permitted to make "deferred cash payments" to secured creditors, as long as the payments amount to the full value of the creditors' claims (i.e., carry an appropriate rate of interest).

The Subordinated Noteholders and Senior Lien Noteholders opposed the Plan.

The Senior Lien Noteholders opposed the Plan, in part, because the replacement notes they received carried basically risk-free interest rates (of 4.1 percent and 4.85 percent,

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respectively, for the two classes of notes) which, they asserted, failed to give them the present value of their claims as required by the Bankruptcy Code. The Plan also deprived the Senior Lien Noteholders of the benefit of the "make-whole" provision (which provides for prospective or "make-whole" interest when bonds are redeemed prior to maturity).

The Subordinated Noteholders contended that they were not in fact subordinated to the Second Lien Notes, and were thus improperly deprived of recovery by the Plan.

The Senior Lien Noteholders and Subordinated Noteholders aggressively appealed the Plan's confirmation. On appeal, the district court affirmed the confirmation order, finding, in relevant part: (i) the below market interest rate that the bankruptcy court selected for the Senior Lien Notes did not run afoul of the bankruptcy code; (ii) the Subordinated Notes' indentures unambiguously prioritized the Second Lien Notes over the Subordinated Notes; and (iii) the Senior Lien Noteholders were not entitled to the make-whole premium.

Second Circuit Holdings

The Second Circuit reversed the district court's holding regarding the interest rate and otherwise affirmed the district court's order. The four key holdings follow:

1. **The Second Circuit adopted the Sixth Circuit's two-part process for selecting an interest rate in Chapter 11 cramdown situations: (1) Where an efficient market exists, the market rate should apply; but (2) where no efficient market exists, the "formula" approach should apply.**

As a result of the cramdown, the Senior Lien Noteholders received replacement notes repaying their claim over time. Following *Till*, the district court ruled that the "formula" approach should determine the applicable interest rate, which the bankruptcy court had selected as rates of 4.1 percent for the First Lien Notes and 4.85 percent for the 1.5-Lien Notes—both of which were (largely) below market and did not reflect credit risk. In the bankruptcy proceeding, however, the Senior Lien Noteholders had presented evidence of the applicable "market rate" around the time of the Plan confirmation. Specifically, in preparation for a possible cash-out payment to the Senior Lien Noteholders, MPM had sought lenders to provide exit financing. Lenders quoted MPM rates of interest between 5 percent and 6+ percent. The First Lien Noteholders argued that, at such rates, they would have received approximately $150 million more than the Plan offered.

The "formula" method was adopted by the plurality opinion in *Till* in the context of a Chapter 13 debtor's sub-prime auto-loan. Chapter 13, like Chapter 11, contains a cramdown provision and allows debtors to provide secured creditors with future property distributions like deferred cash payments, so long as creditors receives the full value of their claims. 11 U.S.C. §§ 1325(a)(5)(B)(ii). The *Till* plurality ruled that bankruptcy courts should determine the interest rate as follows:

> (1) Begin with a largely risk-free interest rate, (i.e., the "national prime rate) . . . which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default;"
>
> (2) Thereafter, hold a hearing to determine a proper plan-specific risk adjustment to that prime rate, whereby the debtor and creditors may present evidence.

The *Till* plurality noted that courts applying the "formula" approach had generally approved adjustments of 1-3 percent above the prime rate. *Till*, however, did not conclusively establish whether the formula rate was required in Chapter 11 cases. Although *Till* noted that the "formula" approach might be proper in the Chapter 11 context, it also noted, in footnote 14 of the opinion, that:

> "[In Chapter 13 cramdowns] there is no free market of willing cramdown lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." 541 U.S. at 476 n.14 (Emphasis in original.) (Internal citation omitted.)

In *Momentive*, the Second Circuit held that the "formula" approach was inappropriate in the context of Chapter 11, stressing that "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." (Internal citation omitted.) The court noted that, unlike in Chapter 11 cases, in Chapter 13 cases dealing with a sub-prime loan, "'value' can be elusive because the market is not necessarily efficient and the borrower is typically unsophisticated." Thus, even though it might be a "complex task," where an efficient market may exist to generate an interest rate that is acceptable to sophisticated parties dealing at arm's length, the Sixth Circuit's approach should apply:

> "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."

Accordingly, the Second Circuit remanded to the bankruptcy court to assess whether an efficient market rate could be ascertained, and, if so, to apply it to the replacement notes.

Practical Consequences: In the Second Circuit, secured creditors are now armed with a shield against Chapter 11 "cramdown" plans that provide for them to receive take-back debt at below-market interest rates. This "market rate" shield, along with the cost associated with such two-step litigation ((i) whether an efficient market for secured creditor's debt exists; and if so, (ii) what market rate applies), generally will improve the likely recovery for secured creditors. The *Momentive* court acknowledged that such a task can be a "complex" undertaking.

2. The Senior Lien Noteholders were not entitled to a "make-whole premium" because the indentures provided that the premium would be due only in the event of an "optional redemption," not an acceleration caused by bankruptcy.

The indentures governing the Senior Lien Notes contained "Optional Redemption Clauses" which provided for the payment of a "make-whole premium" if MPM were to "redeem the Notes at its option" before their maturity date. The purpose of the provision was to ensure that the noteholders would be compensated for future interest payments, of which they would be deprived if the notes were redeemed before their maturity date.

The district court concluded that the Senior Lien Noteholders were not entitled to the make-whole premium because an acceleration brought on by bankruptcy does not constitute an "optional redemption." The Senior Lien Noteholders appealed, making three arguments: (i) they are entitled to the make-whole under the indentures' Optional Redemption Clauses; (ii) they are entitled to it under the indentures' Acceleration clauses; and (iii) even if the indentures did not allow for the make-whole premium to be paid upon acceleration, they should not have been barred from exercising their contractual right to rescind acceleration and obtain the premium.

The Second Circuit rejected all three arguments and affirmed the ruling of the district court for the following reasons:

First, as in *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013), the bankruptcy filing accelerated the date of maturity to the date of the petition. Any payment made on the notes thereafter would be post-maturity, rather than a "redemption," which is a repayment of a debt security *at or before* maturity. Even so, MPM's obligation to issue the replacement notes was mandated by the Automatic Acceleration Clauses, and thus was not made at MPM's "option."

Second, the indentures' Acceleration Clauses accelerated payment of the Senior Lien Notes under a defined Event of Default, one of which was the filing of a voluntary bankruptcy petition. While most Events of Default allow Senior Lien Noteholders the *option* to accelerate payment, this particular provision led to an automatic acceleration upon filing of a voluntary bankruptcy petition. Moreover, even though the Acceleration Clauses require that "premium, if any" be paid upon automatic acceleration, there was no make-whole premium due here because the Optional Redemption Clauses were never triggered.

Third, as held in *AMR*, the Senior Lien Noteholders were barred from exercising their contractual right to rescind the acceleration triggered by the debtor's bankruptcy filing because it would be "an attempt to modify contractual rights," and would serve as an "end-run around their bargain."

Practical Consequences: *Momentive* represents a split between the Second Circuit and Third Circuit on whether a debtor that voluntarily files for bankruptcy must pay noteholders the interest lost on notes redeemed before their expected maturity under an indenture's "make-whole" provision. In 2016, the Third Circuit, in *In re Energy Future Holding Corp.*, 842 F.3d 247 (3d Cir. 2016) held that an indenture's acceleration provision, which provided that the notes matured upon bankruptcy, did not extinguish the debtor's obligation to pay the "make-whole" premium to noteholders. I*n re Energy Future Holding Corp.* expressly rejected the *Momentive* district court's holding(i.e., that the words "premium, if any . . ." are insufficient to require make-whole payment), stating that the holding "conflicts with that indenture's text and fails to honor the parties' bargain." Thus, this Circuit split may incent debtors to file in the Second Circuit (e.g., New York) rather than the Third Circuit (e.g., Delaware) in order to avoid an indenture's "make whole" obligation. (Note however, the Second Circuit may present a conundrum for debtors that have make-whole provisions to address, but also anticipate having to cramdown a plan against secured creditors.) As a practical matter, however, specificity in drafting remains of paramount importance in the interpretation of enforceability of "make whole" provisions in a bankruptcy context.

3. The indenture was ambiguous about whether the Subordinated Notes' claims were subordinate to the Second Lien Noteholders' claims, but the extrinsic evidence favored the priority of the Second Lien Notes.

The Subordinated Noteholders appealed the district court's determination that, under the unambiguous indenture, their claims were subordinate to those of the Second Lien Noteholders and thus would receive no recovery. The Second Circuit reached the same conclusion, but unlike the district court, it found the indenture provision to be ambiguous.

The Subordinated Noteholders had argued that, under Section 10.01 of the indenture, the Second Lien Notes would only stand in priority if they constitute "Senior Indebtedness":

> "[The Subordinated Notes are] subordinated in right of payment . . . to the prior payment in full of all existing and future ***Senior Indebtedness*** of the Company . . . [O]nly the Indebtedness of the Company that is ***Senior Indebtedness*** of the Company shall rank senior to the Securities . . ." (Emphasis added.)

Because they were not subordinate in right of payment, the Second Lien Notes indisputably satisfied the definition of "Senior Indebtedness":

> "all Indebtedness . . . unless the instrument creating or evidencing the same . . . expressly provides that such obligations are subordinated ***in right of payment*** to any other Indebtedness of the Company." (Emphasis added.)

However, the definition of "Senior Indebtedness" was subject to certain exceptions; the "Fourth Proviso Exception" created an ambiguity:

> "any Indebtedness or obligation of the Company . . . that by its terms is ***subordinate or junior in any respect*** to any other Indebtedness or obligation of the Company . . . including any Pari Passu Indebtedness." (Emphasis added.)

The Subordinated Noteholders argued that the Second Lien Noteholders were thus exempted from the definition of "Senior Indebtedness" because they are, for example, subordinate to the First Lien Notes.

The district court concluded that the Fourth Proviso Exception's reference to "subordinate . . . in any respect" unambiguously referred to *payment* subordination rather than *lien* subordination. Thus, even though the liens supporting the Second Lien Notes were, in fact, subordinate to other notes, the Second Lien Notes were not carved out of the "Senior Indebtedness" definition because they were not subordinate in payment to other note classes.

The Second Circuit disagreed, finding the Fourth Proviso Exception ambiguous because it did not specifically state "subordinate . . . ***in right of payment***"—a term used in other provisions of the indenture—but instead broadly referred to indebtedness that was "subordinate . . . ***in any respect***," which would include lien subordination. The Second Circuit observed that, if the district court was correct that that the Fourth Proviso Exception referred to debt that was subordinated *in right of payment*, there would be no need for the definition of "Senior Indebtedness" to include a more limited carve-out for debt "subordinated in right of payment."

Because the contract was ambiguous, the court pointed to the extrinsic evidence to arrive at the determination that the Subordinated Noteholders' claims were, in fact, subordinate to those of the Second Lien Noteholders: (1) MPM had repeatedly represented to the Securities Exchange Commission in Form 8-Ks, 10-Ks, and prospectuses that the Second Lien Notes constituted "Senior Indebtedness"; (2) Subordinated Noteholders received copies of all such SEC filings, as contractually required; (3) the interpretation advanced by the Subordinated Noteholders would cause the springing Second Lien Notes' security interest, which was intended to enhance their protection, to actually undermine it instead (by stripping them of their status as Senior Indebtedness); (4) the Subordinated Noteholders' proposed interpretation that the Fourth Proviso's "in any respect" clause includes all junior liens would necessarily mean that no senior note classes would constitute "Senior Indebtedness" because each was secured by a junior lien in some respect (e.g., even the First Lien Notes were secured in part by a second priority lien).

Practical Consequences: This holding reinforces the lesson that language concerning debt order or priority should be carefully drafted, particularly where skilled counsel can be expected to exploit even arguable ambiguities in the language used. The Second Lien Notes appeared to meet the definition of "Senior Indebtedness" and take priority over the Subordinated Notes. But, that appearance was undone in part by the "Senior Indebtedness" exception for "Indebtedness . . . subordinate or junior *in any respect*." Ambiguity in the language resulted in the Court's reliance on SEC filings and other extrinsic evidence which may be outside of the direct control of the affected noteholders.

4. The appeals should not be dismissed as equitably moot.

The principle of equitable mootness allows appellate courts to dismiss bankruptcy appeals "when . . . even though effective relief could conceivably be fashioned, implementation of that relief would be inequitable." I*n re Motors Liquidation Co.*, 829 F.3d 135, 167 (2d Cir. 2016) (Internal quotation omitted.) The doctrine requires appellate courts to weigh the need for finality in bankruptcy proceedings against an appellant's right to relief and review. Where—as in *Momentive*—a reorganization plan is substantially consummated, an appeal is presumed to be equitably moot. That presumption, however, is overridden when each of the five factors (emphasis on the fifth) set forth in *In re Chateaugay Corp.*, 988 F.2d 322, 325 (2d Cir. 1993) are present: (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 Second Circuit weighed the *Chateaugay* factors in declining to dismiss the appeals as equitably moot. The court noted that the appellants were diligent in immediately objecting to the Plan and promptly seeking a stay in three different courts.

The debtors expressed concern that the appeals, if granted, would alter an important aspect of the Plan (i.e., the noteholders' recovery), which was formed by an intense, multi-party negotiation, and would thus cast doubt on the Plan's viability. The court disagreed because its holding was limited in nature—remanding to the bankruptcy court only to determine the interest rate applicable to the Senior Lien Noteholders' replacement notes—and would therefore cause no such chaos. At most, the new interest payment would incur an additional annual payment of $32 million over seven years. The court's rejection of the other issues on appeal prevented the debtors from, for example, having to pay an additional $200 million to satisfy the Senior Lien Noteholders' make-whole premium, or to make a redistribution to the Subordinated Noteholders.

Practical Consequences: It is unlikely that this opinion will add significantly to the existing jurisprudence on equitable mootness, but it is a Circuit Court-level opinion and provides a roadmap for avoiding application of the doctrine. In order to ensure that their appeals will not be stricken as "equitably moot," creditors should consistently and aggressively oppose unfavorable aspects of a reorganization plan prior to confirmation. When possible, creditors should ensure that their challenges are narrowly tailored and precise, as mootness findings are favored more when the requested relief on appeal may threaten a debtor's ability to emerge from bankruptcy. Here, one of the Second Circuit's primary reasons for casting aside the equitable mootness argument was that its holding only caused the debtor to incur an additional payment of $32 million over seven years, a relatively small imposition compared to the overall composition of Debtors' Plan obligations.

Conclusion

Although the opinion addresses many issues, the Second Circuit's holding in *Momentive* is significant mostly because it is favorable to secured creditors, who now have a substantive means to potentially augment their recovery in cramdown situations. The holding also means that litigation of the cramdown interest rate may become more expensive, as parties will clash over the existence of an efficient market and, if one exists, the appropriate market rate of interest.

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