Second Circuit Holds Momentive Noteholders May Be Entitled to Market Interest Rate on Replacement Notes, Not Entitled to Make-Whole Premium

October 23, 2017

In a much-anticipated decision, on October 20, 2017, the U.S. Court of Appeals for the Second Circuit concluded that (1) the Bankruptcy Court erred in not determining whether an efficient market existed to calculate the interest rate under the cramdown standard for secured creditors and (2) the senior lien noteholders were not entitled to payment of a make-whole premium.[1] To the relief of senior secured creditors, the Second Circuit's decision adopts a two-part test of applying a market interest rate, if an efficient market exists, to take-back debt in a cramdown, and applying the *Till* formula method only if an efficient market does not exist. At the same time, the decision introduces a circuit split on make-whole payments, compared to last year's *Energy Future Holdings* decision by the Third Circuit,[2] which required the payment of a make-whole premium under similar circumstances to *Momentive* (we discuss the *Energy Future Holdings* decision in greater detail **here**). Additionally, the decision continues the recent trend of eroding the equitable mootness doctrine[3] by holding that the payment of additional annual interest of $32 million for seven years would not threaten Momentive, if a market-interest rate were applied to the replacement notes.[4]

Background

Momentive Performance Materials Inc. and its affiliated debtors formulated a plan of reorganization against the backdrop of a dispute with oversecured holders of $1.0 billion of first lien notes and $250 million of 1.5 lien notes as to the noteholders' entitlement to a "make-whole" premium in addition to unpaid principal and accrued interest. In light of this dispute, the plan gave the noteholders the option of either (1) accepting the plan, waiving any make-whole claim they might have, and receiving payment in cash in full, or (2) rejecting the plan, preserving their right to argue for a make-whole payment, and receiving replacement notes with a principal amount equal to their allowed claims but paying below-market interest rates compared to the exit financing rates quoted to Momentive. Both the first lien and 1.5 lien noteholders voted overwhelmingly to reject the plan, and filed confirmation objections, asserting their entitlement to make-whole payments and arguing that the treatment afforded to them by the plan—as a

[1] *In re MPM Silicones, LLC*, Case No. 15-1682 (2d Cir. Oct. 20, 2017) [ECF No. 256].

[2] *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d. Cir. 2016).

[3] *See*, *e.g.*, *Ahuja v. LightSquared Inc.*, 644 F. App'x 24, 27 (2d Cir. 2016) (appeal was not equitably moot even though the plan was substantially consummated because the court could order at least some effective relief in the form of monetary damages without "knocking the props out from under completed transactions or affecting the reemergence of the debtor from bankruptcy"); *In re Sunnyslope Hous. Ltd. P'ship*, 818 F.3d 937 (9th Cir. 2016); *In re Transwest Resort Properties, Inc.*, 801 F.3d 1161 (9th Cir. 2015).

[4] The Second Circuit also affirmed the decisions of the lower courts, although "for somewhat different reasons," that the subordinated notes were subordinate to the second lien notes and, as a result, that Momentive's plan complied with the subordinated notes' indenture in providing no distribution to the subordinated notes. While the lower courts found the relevant indenture provisions unambiguous, the Second Circuit found the provisions ambiguous but resolved the ambiguities in favor of the debtors.

consequence of their rejection—was not "fair and equitable" as required by 1129(b) of the Bankruptcy Code.

The Bankruptcy Court confirmed Momentive's plan despite these objections, concluding in a lengthy bench ruling that the indentures did not require payment of the make-whole premium, and that a below-market interest rate on the replacement notes complied with the Bankruptcy Code's cramdown provision. The U.S. District Court for the Southern District of New York upheld the decision of the Bankruptcy Court, and the indenture trustees appealed the decision to the Second Circuit.

Second Circuit's Analysis

Interest Rate Dispute

The Second Circuit first considered whether the interest rates on the replacement notes issued to the first lien and 1.5 lien noteholders were adequate to meet the so-called "cramdown standard" of section 1129(b) of the Bankruptcy Code applicable to rejecting classes of secured creditors. Section 1129(b) requires that, if a plan does not provide for the immediate payment of secured creditors, it must provide them with "deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." Put another way, the present value of secured creditors' replacement notes must equal the value of their secured claims.

The lower courts held that the below-market interest rates on the replacement notes, which were calculated by slightly adjusting upward the yield on treasury notes of matching maturity to account for additional risk, satisfied the cramdown standard. In doing so, they relied significantly on the Supreme Court's endorsement of the "prime plus" or "formula" method of calculating chapter 13 cramdown interest in its plurality opinion in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). The prime plus or formula method of calculating interest starts first with the prime rate and then adjusts upward to reflect credit and collateral risk. The Supreme Court noted approvingly that courts applying this method had typically set a risk premium of between 1.0% and 3.0% over the prime rate.

The *Till* decision concerned the calculation of cramdown interest on replacement notes distributed to a secured creditor under chapter 13 of the Bankruptcy Code, which is used for individual bankruptcies. The text of the chapter 13 cramdown provision is substantially identical to the portion of the chapter 11 cramdown provision applicable to the Momentive noteholders. In a much-discussed footnote, the Supreme Court reflected on the possibility, however, that chapter 11 cramdown interest could be calculated differently:

> Because every cramdown loan is imposed by a court over the objection of the secured creditor, 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.*** In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

Many other courts relied on this footnote to conclude that market rates should not be ignored where an efficient market exists. The Second Circuit devoted a significant portion of its opinion to revisiting *Till*, and observed that *Till* "made no conclusive statement as to whether the 'formula' rate was generally required in Chapter 11 cases." As a result, the Second Circuit adopted the Sixth's Circuit's two-step approach to selecting an interest rate in a Chapter 11 cramdown:

> [T]he 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.[5]

This approach, the court stated, "best aligns with the [Bankruptcy] Code and relevant precedent," including long-standing Supreme Court precedent which dictates that "the best way to determine value is exposure to a market."[6]

The Second Circuit observed that other courts, including the Fifth Circuit in *In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324 (5th Cir. 2013), have held that markets for financing are efficient where, for example, "they offer a loan with a term, size and collateral comparable to the forced loan contemplated under the cramdown plan." The Fifth Circuit in *Texas Grand Prairie Hotel* further noted that courts, including the Sixth Circuit, have rejected arguments that the existence of tiered financing establishes efficient markets since it bears no resemblance to a single, secured loan contemplated under a cramdown plan.[7] Instead, courts look to whether anyone "in this market today would loan this loan to the debtors." The Second Circuit suggested in *Momentive* that an efficient market may exist for notes similar to the replacement notes but remanded the issue of whether an efficient market exists to the Bankruptcy Court.

Whether Judge Drain will decide that an efficient market exists on the remand is an open question. In his bench ruling, Judge Drain noted that "it is highly unlikely that there will ever be an efficient market that does not include a profit element, fees and costs, thereby violating *Till* and *Valenti*'s first principles, since capturing profit, fees and costs is the marketplace lender's reason for being." Judge Drain cited the *Texas Grand Prairie Hotel* decision approvingly, in which the Fifth Circuit noted that "[w]hile courts often acknowledge that *Till*'s Footnote 14 appears to endorse a 'market rate' approach under Chapter 11 if an 'efficient market' for a loan substantially identical to the cramdown loan exists, courts almost invariably conclude that such markets are absent." The Second Circuit opinion could, however, be read to downplay Judge Drain's concern about compensating lenders for profits, fees and costs. The Second Circuit approvingly cited the testimony of the first lien noteholders' expert, who testified that when notes are priced at the market the noteholders are "being compensated for the underlying risk that they are taking" and not for any "imbedded profit."

Make-Whole Dispute

The Second Circuit next considered whether the noteholders were entitled to make-whole payments, which required a determination of (1) whether there was a redemption, (2) whether the redemption was optional, and (3) whether the noteholders could rescind an acceleration postpetition. The court answered all three queries in the negative.

First, the Second Circuit agreed with the District Court and the first lien noteholders, which conceded in their brief, that the term "redemption" generally refers only to pre-maturity repayments of debt. The Second Circuit then, relying on *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013), held that since acceleration of debt moves the maturity of that debt to the acceleration date, and since issuance of the replacement notes occurred post-acceleration, the issuance of the replacement notes by definition could not be a

---

[5] *See MPM Silicones*, Case No. 15-1682, at 19-20 (quoting *In re American HomePatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005)).

[6] *See Id.* at 20 (quoting *Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 457 (1999)).

[7] *See In re Texas Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 337 (5th Cir. 2013) (citing *Am. HomePatient*, 420 F.3d at 568).

prepayment and, as a result, the transaction was not a redemption for purposes of the optional redemption clause in the indenture.

The Second Circuit then analyzed the circumstances of the issuance of the replacement notes to determine whether those actions were "optional." The Second Circuit concluded, citing *AMR*, that "the obligation to issue the replacement notes came about automatically" and that "[a] payment made mandatory by operation of an automatic acceleration clause is not one made at MPM's option."

Finally, the Second Circuit agreed with lower courts that the noteholders' postpetition invocation of their contractual right to rescind the acceleration triggered automatically by a bankruptcy filing was barred by the automatic stay as an attempt to modify contract rights. Relying again on its decision in *AMR*, the Second Circuit stated that the right to rescind acceleration in bankruptcy would serve as "an end-run around [creditors'] bargain by rescission."

Energy Future Holdings Circuit Split

The Second Circuit's make-whole decision creates a circuit split with the Third Circuit which, in *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016), held that noteholders were entitled to payment of an optional redemption premium at the make-whole price as a result of the repayment of their notes in a bankruptcy proceeding. In that case, the Third Circuit held, under New York law, a redemption may occur either before or after an automatic acceleration triggered by the filing of a bankruptcy petition. Further, the Third Circuit concluded that despite the automatic nature of acceleration under the indentures, the debtor's note repayments were voluntary, particularly because the noteholders had sought to rescind the acceleration and did not want to be repaid. In the face of this circuit split, companies and creditors are well advised to be clear and explicit in the terms of the indentures as to whether make-whole payments are owed after a bankruptcy filing by the companies.[8]

Equitable Mootness

Last, the Second Circuit addressed Momentive's argument that the noteholders' appeals should be dismissed as equitably moot. This continues a recent trend from certain courts of watering down the strength of the equitable mootness doctrine, a prudential doctrine invoked by bankruptcy courts to avoid disturbing plans of reorganization once they are implemented. Where, like in this case, a plan has been substantially consummated, there is a presumption that an appellant's challenge has been rendered equitably moot. That presumption, however, may be overcome if the following five factors are met:

> (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.

Momentive argued that granting the relief requested by the noteholders would "alter a critical piece of the Plan resulting from intense-multi-party negotiation, thereby impact[ing] other terms of the agreement and throw[ing] into doubt the viability of the Plan," and accordingly such relief "would cause debilitating financial uncertainty" to the emerging company. The Second Circuit disagreed, stating that it was not persuaded that payment of, by Momentive's own calculation, approximately $32 million in annual payments over seven years as a result of an increased interest rate on the replacement notes would

[8] Explicit language is not necessarily the end to the analysis in allowing a make-whole claim. Debtors may also challenge that the make-whole is an unenforceable penalty or on account of unmatured interest. *See In re Ultra Petroleum Corp.*, Case No. 16-32202 (Bankr. S.D.T.X. Sept. 21, 2017) [ECF No. 1569] (make-wholes may be unenforceable liquidated damages provisions under New York law if "the amount fixed is plainly or grossly disproportionate to the probable loss").

threaten Momentive's emergence or otherwise fail the five factor test. The Second Circuit suggested, however, that this conclusion may have been different if Momentive had been ordered to pay the nearly $200 million in asserted make-whole claims, or if redistribution had been required to comply with the subordinated notes' indenture.

Takeaways

The Second Circuit's decision is good news for secured creditors, who have been facing threats of cramdown with below-market take-back debt in restructuring negotiations since the original *Momentive* decision. Since Judge Drain's bench ruling at the confirmation hearing on Momentive's plan, there has been a real risk that unsecured creditors could extract value from the debtor at the expense of secured creditors. The Second Circuit's decision should ameliorate that risk, although the two-step approach adopted by the Second Circuit could result in expensive litigations between debtors and secured creditors as to whether there exists an efficient market and, if so, what the efficient market rate should be.

On the other hand, the circuit split between the Second and Third Circuits on the make-whole issue has the potential to increase forum shopping for distressed issuers with possibly significant make-whole obligations. We also expect future issuers to clearly draft around the issue of whether they have any obligation to pay a make-whole premium following a default or an acceleration in bankruptcy, with healthy issuers seeking to foreclose that possibility and distressed issuers allowing for that possibility.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Donald S. Bernstein	**212 450 4092**	**donald.bernstein@davispolk.com**
Timothy Graulich	**212 450 4639**	**timothy.graulich@davispolk.com**
Marshall S. Huebner	**212 450 4099**	**marshall.huebner@davispolk.com**
Darren S. Klein	**212 450 4725**	**darren.klein@davispolk.com**
Brian M. Resnick	**212 450 4213**	**brian.resnick@davispolk.com**
Damian S. Schaible	**212 450 4580**	**damian.schaible@davispolk.com**
Eli J. Vonnegut	**212 450 4331**	**eli.vonnegut@davispolk.com**
Jacob Weiner	**212 450 4906**	**jacob.weiner@davispolk.com**

© 2017 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's **privacy policy** for further details.