

Client Alert

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Second Circuit Remands *Momentive* Back to Bankruptcy Court

Bankruptcy Courts Must First Consider Efficient Market in Determining Cramdown Interest Rates in Chapter 11 Plans

In the *Momentive* case,¹ the United States Court of Appeals for the Second Circuit became the latest court to weigh in on chapter 11 cramdown interest rates for secured creditors. In short, the Second Circuit agreed with the Sixth Circuit and ruled that bankruptcy courts must first look to apply the rate that an “efficient market” would charge. If no market rate can be demonstrated, then and only then should courts apply a “formula rate” of prime plus, generally 1 to 3 percent.

Where a class of secured creditors votes to reject a chapter 11 plan that provides for recoveries junior in priority to them, that plan may only be confirmed if the secured creditors are either paid in full or if the plan provides the secured creditors with deferred payments of a value at least equal to the allowed amount of the secured claim as of the effective date of the plan. A plan confirmed over the rejection of at least one class of creditors is commonly referred to as a “cramdown” plan.

Courts have long grappled with the question of fixing a “cramdown” interest rate. Courts generally start from the 2004 U.S. Supreme Court case, *Till v. SCS Credit Corp.*² *Till* is helpful in that it examines cramdown interest rates in bankruptcy, but it is imperfect on a number of grounds. Most significantly, *Till* was a chapter 13 case concerning an individual debtor. In *Till*, to set the cramdown interest rate, a plurality of four justices applied the “formula approach” of applying the prime (or similar base rate) and generally adding 1 to 3 percentage points, depending on the creditworthiness of the debtor.

Courts in chapter 11 cases generally look to the plurality opinion, but the greatest difficulty in applying *Till* to chapter 11 cases is that the plurality

attorneys

Michael S. Fox
mfox@olshanlaw.com
212.451.2277

Adam H. Friedman
afriedman@olshanlaw.com
212.451.2216

Jonathan T. Koevary
jkoevary@olshanlaw.com
212.451.2265

Lauren B. Irby
lirby@olshanlaw.com
212.451.2379

practice

Business Restructuring &
Bankruptcy

¹ *In re: MPM Silicones, L.L.C.*, Nos. 15-1771; 15-1682; 15-1824 (2d Cir. Oct. 20, 2017).

² 541 U.S. 465 (2004).

hints that it might have ruled differently in a chapter 11 case. This has resulted in some courts applying the formula approach (prime plus 1 to 3 percent), while others look to the market to determine what the appropriate interest rate should be (i.e., the “market approach”).

In *Momentive*, the chapter 11 plan provided two payment options to the holders of \$1.3 billion of senior-lien secured notes. The plan would immediately pay cash in full to the noteholders if the class voted to accept the plan, provided that they waive a \$250 million “make-whole” premium provided for under the indentures. Alternatively, if the noteholders voted to reject the plan, the noteholders would receive replacement notes paying out their allowed claims over time, with interest. The noteholders elected to reject the plan, implementing chapter 11’s cramdown provisions.

The bankruptcy court in *Momentive* followed the formula approach without determination of an “efficient market” that other courts have applied. For example, the Sixth Circuit in *American HomePatient* concluded that courts must first see if there is an efficient market, and only if there is none, to apply the formula approach.³

The *Momentive* bankruptcy court concluded that an efficient market approach was inappropriate, and on the intermediate appeal, the district court agreed.⁴ Both the bankruptcy court and the district court reasoned that the market approach “overcompensates creditors because the market lending rate must be high enough to cover [irrelevant] factors, like lenders’ transaction costs and overall profits.”⁵ The lower courts emphasized that, “[t]he objective of [the cramdown statutes] is to put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately. The purpose is not to put the creditor in the same position that it would have been in had it arranged a ‘new’ loan.”⁶ Thus, the lower courts applied the formula rate only.⁷

The Second Circuit disagreed and adopted the *American HomePatient* test, concluding that the bankruptcy court must first determine if efficient market rates existed, rather than categorically applying the formula rate in chapter 11 cases. The Second Circuit adopted this analysis, and pointed to the noteholders’ expert testimony at the confirmation hearing that showed that if the noteholders accepted the cash-out payment, rather than reject the

attorneys

Michael S. Fox
mfox@olshanlaw.com
212.451.2277

Adam H. Friedman
afriedman@olshanlaw.com
212.451.2216

Jonathan T. Koevary
jkoevary@olshanlaw.com
212.451.2265

Lauren B. Irby
lirby@olshanlaw.com
212.451.2379

practice

Business Restructuring &
Bankruptcy

³ *In re American HomePatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005).

⁴ *In re MPM Silicones, LLC*, 2014 WL 23 4436335, at *25 (Bankr. S.D.N.Y. Sept. 9, 2014), aff’d, 531 B.R. 321 (S.D.N.Y. 2015).

⁵ *Id.* at *25 (quoting *Till*, 541 U.S. at 477).

⁶ *Id.* (citing *In re Valenti*, 105 F.3d 55 (2d Cir. 1997)).

⁷ In addition, at least one circuit has declined to apply the efficient market test of *American HomePatient* because, “courts almost invariably conclude that such markets are absent” and such an analysis would thus be fruitless. *In re Texas Grand Prairie Hotel Realty L.L.C.*, 710 F.3d at 333 (5th Cir. 2013).

Plan, *Momentive* would have to secure exit financing to cover the lump-sum payment. In anticipation of that possibility, *Momentive* had sought lenders for such financing, who quoted rates of interest ranging in excess of 5 to 6 percent, higher than the formula rate.⁸ **The Second Circuit concluded that where there is an efficient market which creates an interest rate acceptable to “sophisticated parties dealing at arms-length . . . such rate is preferable to a formula improvised by a court.”**⁹

The Second Circuit acknowledged that the test was not necessarily an easy one and that application of the efficient market test, while straightforward in some cases, could be complex in others. Nevertheless, the Second Circuit maintained that such additional analysis is no more difficult than analyses bankruptcy courts already conduct. The Second Circuit remanded the case to the bankruptcy court to determine whether the market rate exists and, if so, to apply that rate rather than the formula rate.

In following the “efficient market” approach, the *Momentive* decision provides important creditor-friendly guidance to both par and distressed debt investors. The Second Circuit’s *Momentive* decision is also instructive in that it provides updated guidance on a number of other bankruptcy issues, including with respect to make-whole premiums and the doctrine of equitable mootness. Stay tuned for an update on these fronts.

Please feel free to contact the Olshan attorney with whom you regularly work or one of the attorneys listed below if you would like to discuss this matter.

attorneys

Michael S. Fox
mfox@olshanlaw.com
212.451.2277

Adam H. Friedman
afriedman@olshanlaw.com
212.451.2216

Jonathan T. Koevary
jkoevary@olshanlaw.com
212.451.2265

Lauren B. Irby
lirby@olshanlaw.com
212.451.2379

⁸ *In re: MPM Silicones, L.L.C.*, Nos. 15-1771; 15-1682; 15-1824 (2nd Cir. Oct. 20, 2017) (citing *In re: MPM Silicones, L.L.C.*, 2014 WL 4436335, at *29).

⁹ *Id.* at 21.

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