Insolvency and Restructuring Update

Momentive Ruling May Pave the Road for Below-Market "Takeback Paper" Cramdowns of Secured Creditors

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In a lengthy bench ruling delivered on August 26, 2014, Judge Robert D. Drain of the United States Bankruptcy Court for the Southern District of New York held that Momentive Performance Materials could satisfy the cramdown standard of Section 1129(b) of the Bankruptcy Code as to its oversecured creditors by distributing to them replacement notes paying a below-market interest rate. Rejecting arguments made by the objecting creditors that a market rate of interest was required, Judge Drain approved the use of a rate computed by reference to the prime rate, with an additional margin to compensate the creditors for the risk of non-payment, reasoning that the Bankruptcy Code does not require an interest rate that covers creditors' costs or provides them with a profit. If followed, Judge Drain's ruling may shift the leverage in future cases in favor of debtors and unsecured creditors, potentially enabling them to satisfy secured creditors with long-term replacement notes at below-market rates, thus obviating the need for some debtors to secure takeout exit financing and potentially providing additional value for unsecured creditors at the expense of secured creditors.

Case Background

Momentive and its affiliates formulated a plan of reorganization against the backdrop of a dispute between the debtors and oversecured holders of $1.0 billion of first lien notes and $250 million of 1.5 lien notes[1] 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 sought to "cram down" the noteholders, satisfying their claims with replacement notes, unless they voted to accept the debtors' plan and waive any make-whole claim they might have, in which case they would be paid in cash in full. By rejecting the plan, the holders would preserve their right to argue for make-whole claims, but they would receive, rather than cash, replacement notes with a principal amount equal to their allowed claims, on the following terms:

- The first lien noteholders' replacement notes would have first-priority liens, a seven-year maturity and a fixed coupon equal to the yield on treasury notes of matching maturity, as of the effective date, plus 1.5%, or an estimated total yield of 3.60% at the time of the decision
- The 1.5 lien noteholders' replacement notes would have second priority liens, a seven-and-a-half year maturity and a fixed coupon equal to the yield on treasury notes of matching maturity, as of the effective date, plus 2.00%, or an estimated total yield of 4.10% at the time of the decision

Both the first lien and 1.5 lien noteholders voted overwhelmingly to reject the plan, and filed confirmation objections, both asserting their entitlement to make-whole payments and arguing that the treatment afforded to them by the plan—as a consequence of their rejection—was not "fair and equitable."

[1] "1.5 lien notes" is a colloquial term used to describe notes with second-priority liens where there are additional secured creditors with further subordinated liens.

The Noteholders’ Objections

The noteholders’ primary argument with respect to their plan treatment was that the interest rate on the replacement notes was inadequate 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.” In other words, the present value of secured creditors’ replacement notes must equal the value of their secured claims.

The noteholders argued that replacement notes paying a below-market rate of interest were worth less than their secured claims and thus failed to satisfy the 1129(b) standard. To support the view that the proposed rates were below-market, the noteholders pointed to the debtors’ two pre-arranged credit facilities with the same lien priority as the replacement notes, which were intended to refinance the notes in the event they accepted the plan (or the debtors’ settlement offers) and both paid higher interest rates than the proposed replacement securities. The exit facility arranged to refinance the first lien notes, a term loan facility with a seven-year maturity, had an interest rate of LIBOR plus 4.0% with a LIBOR floor of 1.0%, or an indicative rate of 5.0%. The exit facility arranged to refinance the 1.5 lien notes, a bridge facility backstopping a contemplated notes offering, had an interest rate of LIBOR plus 6.0% with a LIBOR floor of 1.0%, or an indicative rate of 7.0%, subject to 0.5% step-ups every three months to a capped amount.

Grounding their argument in case law, the noteholders pointed to a footnote in the U.S. Supreme Court’s plurality opinion in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004), for the proposition that cramdown interest in chapter 11 should be determined by reference to market rates. *Till* concerned the calculation of cramdown interest on replacement notes distributed to a secured creditor under chapter 13 of the Bankruptcy Code, which concerns individual bankruptcies. Although applicable to a different category of debtor, 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. Interpreting the chapter 13 provision, the Supreme Court endorsed the “prime plus” or “formula” method of calculating chapter 13 cramdown interest that had been employed by some courts, which is calculated by using the prime rate as a starting point and adjusting upward to reflect credit risk 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. In a 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.

Citing this footnote, the noteholders argued that the appropriate interest rate for their replacement notes should be determined by reference to the market rate for loans of equivalent priority. Moreover, in the case at hand, determining this rate did not require speculation or complex evidentiary hearings, as the debtors had marketed and priced exactly such a loan, namely the exit facilities. In the alternative, the noteholders argued that even applying the *Till* “formula approach” method of calculating interest, the replacement notes were mispriced. First, they argued, the debtor incorrectly benchmarked the interest rate based on the treasury rate, whereas the Supreme Court had specifically endorsed the prime rate.

And second, the "market check" provided by the exit credit facilities showed that the spread on the replacement notes was inadequate. Additionally, the noteholders argued that the covenants in the replacement notes were inadequate because they fell short of those in the exit credit facilities.

In response to the noteholders, the Debtors argued that the *Till* formula "is not intended to put current creditors on par with market lenders, but instead to provide for a base rate interest plus some compensation for the risk that such replacement notes are not repaid as scheduled." Accordingly the debtors argued that the *Till* formula is not subject to a market check, even in chapter 11 cases where one is available. Additionally, the debtors justified using treasury yields as the benchmark rate, rather than the prime rate, because the notes' fixed coupon and long-term maturities meant they were better benchmarked off long-term treasury notes than "a short-term, floating rate." They also argued that the terms of the replacement notes, including the covenants, were substantially similar to those in the exit credit facilities. Lastly, they argued that the Debtors' proposed risk premiums were reasonable in light of the debtors' projections.

Judge Drain's Bench Ruling

In a wide-ranging decision that also addressed the noteholders' make-whole claims and other issues, Judge Drain held that *Till*'s formula approach was the correct way of calculating the interest rate on the replacement notes. However, Judge Drain held that the prime rate was the appropriate benchmark and therefore the debtors' proposed coupon, benchmarked off of lower treasury rates, should be increased by 0.50% in the case of the first lien replacement notes and 0.75% in the case of the replacement 1.5 lien notes, yielding an estimated rate at the time of the decision of 4.10% for the replacement first lien notes and 4.85% for the replacement 1.5 lien notes.

Importantly, Judge Drain rejected the implication from footnote 14 of the *Till* decision that the appropriate interest rate for replacement notes in a cramdown context should be set by the market if a market rate is available. Judge Drain reasoned that the *Till* plurality had specifically rejected the "coerced loan" approach to setting the cramdown interest rate, an approach that would require bankruptcy courts to consider evidence about market interest rates. According to *Till*, the coerced loan approach "overcompensates creditors because the market lending rate must be high enough to cover factors . . . like lenders' transaction costs and overall profits." Judge Drain extended this reasoning from chapter 13 cramdown rates to chapter 11 cramdown rates, which he held should likewise "not contain any profit or cost element" and therefore should not reflect market rates. In reaching this conclusion, Judge Drain also looked to the pre-*Till* Second Circuit case of *In re Valenti*, 105 F.3d 55, 59-60 (2d Cir.1997), which applied a formula approach in chapter 11, and was cited approvingly by the *Till* plurality.

Moreover, Judge Drain rejected the noteholders' arguments that the "profit" or "cost" element of the exit facilities was covered by the upfront and availability fees, and therefore the coupon rate of those facilities was an appropriate, profit-free point of reference. Instead, he concluded that the interest rates on the exit facilities contain an "unspecified and unquantified" profit element, making those rates "not consistent with the first principles stated by the court in *Till* and *Valenti*." Therefore, he concluded that the formula approach should be applied using "a base rate that should be riskless or as close to riskless as possible, plus a premium normally in the range of between one to three percent, if at all." On this basis, Judge Drain held that the risk premiums set by the debtors appropriately reflected credit risk and collateral risk, observing that the loan-to-value ratio was between fifty and seventy-five percent and the debtors' business plan, which he accepted as credible, showed significant future deleveraging. In addition, he rejected the argument that the covenants in the replacement notes were inadequate, finding that they were "not materially different on an economic basis from the covenants in the proposed refinancing facilities."

However, Judge Drain also held that the debtors' proposed risk premiums were set too low, because they were benchmarked off treasury yields, whereas the 1.0% to 3.0% risk premiums endorsed in *Till* were benchmarked off the prime rate. In particular, Judge Drain noted that at present, the prime rate for short-term loans is materially higher than the treasury rates for long-term loans, suggesting that the use of the treasury rates substantially underpriced the risk premium. Therefore, Judge Drain held that the first lien replacement notes required an additional 0.50% risk spread—for a total of 2.0%--and the replacement 1.5 lien notes required an additional 0.75% risk spread—for a total of 2.75%.

Future Implications

Over the years, the pendulum has swung back and forth between periods when courts are inclined to fully protect the rights of secured creditors and periods when courts appear inclined to question some of those rights, strengthening the hand of chapter 11 debtors and their unsecured creditors. If not overturned on appeal and if adopted by other courts, Judge Drain's opinion could shift significant additional leverage to debtors and unsecured creditors, enabling them to satisfy secured lenders with long-term replacement notes at below-market rates potentially, in certain circumstances, avoiding the need to secure additional exit financing and providing increased value to unsecured creditors. However, it remains to be seen both whether the decision will be further adopted and how secured financing markets and lenders may respond to this significant new possible risk to recoveries.

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