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Till Next Time: Bankruptcy Court Deals Major Blow to Senior Secured Noteholders and Subordinated Noteholders in Momentive Chapter 11 Case

On August 26, 2014, the U.S. Bankruptcy Court for the Southern District of New York (the "**Bankruptcy Court**") issued a notable decision in the chapter 11 cases of MPM Silicones, LLC and its affiliates (the "**Debtors**") that could have far-reaching implications for future chapter 11 cases, particularly as it strengthens a debtor's ability to cram down a dissenting class of secured creditors with new secured debt at a below market interest rate.

The Bankruptcy Court issued rulings on three issues that could negatively impact creditors in future cases:

> The Bankruptcy Court held that the appropriate interest rate for debt to be issued to a class of dissenting secured creditors under the Bankruptcy Code's cramdown provisions is a risk-free rate equal to the treasury rate[1] ("**Treasury**") plus a risk-adjusted factor in the range of 1%-3%, depending on the facts of the case. The Bankruptcy Court found that the interest rate in such circumstances should not include any profit component for the creditors.

> The Bankruptcy Court concluded that the secured creditors were not entitled to the make-whole premium under the plain language of the indenture because the make-whole was payable only upon an early redemption, which was no longer applicable because the debt had been accelerated as a result of the bankruptcy filing.

> The Bankruptcy Court concluded that subordinated creditors were in fact subordinated to the second lien creditors because the subordination provision was not an anti-layering covenant.

This decision, together with other recent court decisions limiting the right of secured creditors to credit bid, raises the spectre that the pendulum has swung against creditors that pursue litigation rather than compromise, as the secured and subordinated creditors did in this case. In the immediate future, we expect

[1] "Treasury rate" refers to the current interest rate that investors earn on debt securities issued by the U.S. government.

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these sorts of court decisions to drive more restructurings to either consensual out-of-court deals or short, uncontested pre-packaged cases.

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Background

The Debtors submitted a chapter 11 plan for Bankruptcy Court approval (the "**Proposed Plan**") that was supported by a substantial majority of the holders of certain second lien notes (the "**Second Lien Noteholders**"). With respect to the treatment of the Debtors' financial indebtedness, the Proposed Plan provided as follows:

> the holders of $1.1 billion of 8.875% first lien priority senior notes (the "**First Lien Noteholders**") and the holders of $250 million of 10% senior secured notes (the "**1.5 Lien Noteholders**" together with the First Lien Noteholders, the "**Senior Secured Noteholders**") had the option of either (i) voting to accept the Proposed Plan and receiving payment in full in cash of the debt outstanding (but forfeiting any right to a make-whole premium of over $200 million) or (ii) voting to reject the Proposed Plan and receiving seven-year (or 7.5 years for the 1.5 Lien Noteholders) replacement notes secured by collateral at a below market interest rate (the "**Replacement Notes**");

> the claims of the Second Lien Noteholders would be converted into the equity of the reorganized company; and

> holders of $380 million of 11% subordinated notes (the "**Subordinated Noteholders**") that were subordinated in right of payment would not be entitled to any recovery.

The Senior Secured Noteholders voted as a class to reject the Proposed Plan and vigorously opposed the Proposed Plan on the ground that the proposed interest rate for the Replacement Notes did not satisfy the Bankruptcy Code requirements for cramming down a dissenting class of secured creditors. In addition, they argued that they were entitled to a make-whole premium of over $200 million under the plain meaning interpretation of the relevant provisions in the governing indentures. The Subordinated Noteholders also objected to the Proposed Plan on the ground that they were entitled to share in the recovery of the Second Lien Noteholders because the subordination provision in the governing indentures did not render them payment subordinate to the claims of the Second Lien Noteholders. The Bankruptcy Court ruled against both the Senior Secured Noteholders and the Subordinated Noteholders on all three issues.

Appropriate Interest Rate On Replacement Notes

Because the Senior Secured Noteholders did not vote to accept the Proposed Plan, the Proposed Plan could be confirmed only if the debtor could satisfy the requirements for cramming down a dissenting class of secured creditors. Under

the Bankruptcy Code, a plan is confirmable over the objection of a class of secured creditors if a debtor can show that the plan is “fair and equitable.” For purposes of cramdown of a class of secured creditors, this means that the secured creditors must retain the liens securing such claims and receive cash and debt that has a present value equal to the value of the collateral it holds. In cases such as this one, where the value of the collateral is greater than the amount of the aggregate claims of the Senior Secured Noteholders, the key issue is the proposed interest rate on any debt being distributed to the secured creditors, as the present value of the debt depends on this interest rate.

the Bankruptcy Court ruled that the interest rate for debt being issued in a cramdown situation... should not include a profit or cost component because that would be inconsistent with the present value approach contemplated by the Bankruptcy Code’s cramdown provisions.

In this case, the Proposed Plan contemplated that (i) the seven-year secured Replacement Notes being issued to the First Lien Noteholders have an interest rate of Treasury +150 bps (approximately 3.6%) and (ii) the 7.5-year secured Replacement Notes being issued to the 1.5 Lien Noteholders have an interest rate of Treasury + 200 bps (approximately 4.1%). The Senior Secured Noteholders objected, arguing, among other things, that the appropriate interest rate should reflect market rates. In this case, the market rate was easily ascertainable because the Debtors had obtained commitments for an exit financing facility that would have been used to repay the Senior Secured Noteholders had they voted to accept the plan. The exit financing facility had interest rates in the range of 5% to 6.25%.

The Bankruptcy Court disagreed with the Senior Secured Noteholders that they were entitled to a market rate of interest. Relying on the U.S. Supreme Court decision in *Till v. SCS Credit Corp.*[2] and a Second Circuit decision in *In re Valenti*,[3] the Bankruptcy Court ruled that the interest rate for debt being issued in a cramdown situation such as this one should not include a profit or cost component because that would be inconsistent with the present value approach contemplated by the Bankruptcy Code’s cramdown provisions. Instead, the interest rate should reflect a risk-free base rate which would then be increased by a risk adjustment factor that reflected the risks associated with the estate, the nature of the collateral security and the duration and feasibility of the Chapter 11 plan. In general, such risk adjustment should range from 1% to 3% (but should not be based on any market rate).

Based on those principles, the Bankruptcy Court concluded that the risk-free rate should be the Treasury rate (and not the prime rate because that included a profit component) plus a risk-adjusted rate of 2% for the First Lien Noteholders and 2.75% for the 1.5 Lien Noteholders. The Debtors were directed to amend the Proposed Plan accordingly. Although these rates were higher than those

[2] 541 U.S. 465 (2004). In *Till*, the U.S. Supreme Court held that the appropriate interest rate to be applied to installment payments to be paid by a Chapter 13 debtor to a secured creditor whose claim was secured by a lien on the debtors’ truck was the national prime rate as adjusted to reflect the specific risks associated with the debtors.

[3] 105 F.3d 55 (2d Cir. 1997). In *Valenti*, the U.S. Court of Appeals for the Second Circuit determined that the appropriate interest rate to be applied to installment payments to be paid by a Chapter 13 debtor to a creditor whose claim was secured by a lien on the debtors’ automobile was the treasury rate plus a risk-adjusted premium of 1%-3% points, depending on the debtors’ circumstances including prior credit history and the viability of the plan.

contained in the Debtors' Proposed Plan, undoubtedly this ruling should be viewed as a significant defeat for the Senior Secured Noteholders because the Senior Secured Noteholders sought an even higher interest rate.

Make Whole Premium

The Senior Secured Noteholders also argued that they were entitled to a make-whole premium under the applicable provisions of the governing indentures. The indentures provided, "[p]rior to October 15, 2015, [MPM] may redeem the Notes at its option . . . at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium."[4] In addition, the section entitled "Acceleration Provision" provides that, upon certain Events of Default, including MPM's "commenc[ing] a voluntary case" under the Bankruptcy Code, "the principal of, premium, if any, and interest on all the Notes shall ipso facto become and be immediately due and payable without any declaration or other act on the part of the Trustee or any of the Holders." The Senior Secured Noteholders argued that the Proposed Plan contemplated a "redemption" because the Proposed Plan contemplated paying the Senior Secured Noteholders and then cancelling the notes. The Senior Secured Noteholders also sought to rescind the acceleration that occurred as a result of the Chapter 11 filing.

...under New York law, to trigger payment of a make-whole premium upon the automatic acceleration of debt, the acceleration provisions of the applicable debt instrument must provide specifically for the payment of such premium.

The Bankruptcy Court disagreed that the Senior Secured Noteholders were entitled to the make-whole premium. The Bankruptcy Court found that the relevant provisions were not sufficiently specific. The Bankruptcy Court held that under New York law, to trigger payment of a make-whole premium upon the automatic acceleration of debt, the acceleration provisions of the applicable debt instrument must provide specifically for the payment of such premium. Furthermore, consistent with the Second Circuit's decision on a similar issue in the American Airlines[5] Chapter 11 case, the Bankruptcy Court held that the automatic stay prohibited the Senior Secured Noteholders from rescinding the acceleration of the debt and there was not sufficient cause to lift or modify the stay in order to permit the rescission of the note acceleration. As a result, the Senior Secured Noteholders' allowed claim would not include any make-whole premium.

Subordination Indenture

The Subordinated Noteholders argued that the Proposed Plan could not be confirmed because they were entitled to share in the equity being distributed to

[4] "Applicable Premium" means, with respect to any Note on any applicable redemption date, the greater of: (1) 1% of the then outstanding principal amount of such Note; and (2) the excess of: (a) the present value at such redemption date of (i) the redemption price of such Note, at October 15, 2015 (such redemption price being set forth in paragraph 5 of the applicable Note) plus (ii) all required interest payment due on such Note through October 15, 2015 (excluding accrued but unpaid interest), computed using a discount rate equal to the Treasury Rate as of such redemption date plus 50 basis points; over (b) the then outstanding principal amount of such Note.

[5] *U.S. Bank Trust Nat'l Ass'n v. AMR Corp. (In re AMR Corp.)*, 730 F.3d 88 (2d. Cir. 2013).

the Second Lien Noteholders, because the payment subordination provisions in the subordinated indenture did not render their claims subordinate to the claims of the Second Lien Noteholders.

The Subordinated Noteholders relied on, among other things, the definition of "Senior Indebtedness" in the subordinated indenture, which provided any debt that "by its terms is subordinate or junior in any respect to any other indebtedness or obligation of the company" is excluded from the subordination provisions. The Subordinated Noteholders argued that the "junior in any respect" language means that their claims are not subordinated to the claims of the Second Lien Noteholders because the Second Lien Noteholders have liens that are junior to those of the Senior Secured Noteholders.

The Bankruptcy Court disagreed. Applying general contract interpretation principles, the Bankruptcy Court found that the Subordinated Notes Indenture provides for the subordination of debt only and not the subordination of liens – an interpretation that is consistent with the distinctions made between liens and debt throughout the indenture. The Bankruptcy Court also rejected the Subordinated Noteholders' argument that the "in any respect" language was meant to address the so-called anti-layering concern. The Bankruptcy Court noted that debt and anti-layering covenants in the indenture could restrict any additional debt that would be prior in right of payment to the claims of the Subordinated Noteholders.

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Aftermath and Impact

Shortly following the Bankruptcy Court's decision, the Senior Secured Noteholders filed a motion requesting that the Bankruptcy Court permit them to change their votes in order to accept the Proposed Plan. The Bankruptcy Court denied the request, stating that the opportunity for them to accept the Debtors' offer to be paid in full in cash instead of the Replacement Notes had expired and that this was nothing more than a "do-over" that the Bankruptcy Court could not countenance. The Debtors filed an amended Chapter 11 plan providing for an increased interest rate on the Replacement Notes to be distributed to the Senior Secured Noteholders, which the Bankruptcy Court approved. The Subordinated Noteholders filed an appeal challenging the Bankruptcy Court's ruling that their claims are subordinated in right of payment to the claims of the Second Lien Noteholders.[6] It is expected that the Senior Secured Noteholders will file an appeal of the Bankruptcy Court's decision directly to the U.S. Court of Appeals for the Second Circuit.

[6] The Bankruptcy Court also denied the Subordinated Noteholders' motion for a stay of the confirmation of the Debtors' plan pending appeal of the Bankruptcy Court's decision, finding, among other things, that the Debtors would be harmed by having a large contingent liability on their books and being unable to exit Chapter 11, whereas the Subordinated Noteholders would face only minimal risk that their appeals would become equitably moot if the Debtors effectuated their plan.

The Bankruptcy Court's decision certainly has far-reaching implications, particularly because it significantly strengthens a debtor's ability to cram down a dissenting class of secured creditors with debt that has a below market interest rate. The fact that the interest rate for debt in a cramdown situation is to be calculated using a risk-free rate plus a risk-adjusted factor that has few meaningful parameters increases the uncertainty for and heightens the risk to secured creditors that are considering whether to accept the proposed Chapter 11 plan. Further, the fact that the debt will likely have a below market interest rate could depress trading prices for the pre-petition debt and the new debt that is to be issued under the plan.

Although the Bankruptcy Court's decision to apply a plain meaning interpretation to the indenture provisions governing the make-whole premiums and the subordination language is consistent with prior case law, it is a warning to purchasers of newly issued and distressed debt to be mindful of the precise language in the applicable provisions in their credit documents. It cannot be assumed that a court will apply a reading that is favorable to the debt holders.

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