District Court Decision on MPM Silicones Bankruptcy Case Highlights Risks for Secured Lenders

Skadden

05/14/15

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Ron E. Meisler
Chicago
312.407.0549
ron.meisler@skadden.com

Christopher M. Dressel
Chicago
312.407.0968
christopher.dressel@skadden.com

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55 N. Wacker Drive
Chicago, Illinois 60606
312.407.0700

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

In a May 4, 2015, decision, the U.S. District Court for the Southern District of New York rejected secured lenders' appeals of a controversial bankruptcy court decision confirming the Chapter 11 plan of reorganization of MPM Silicones, LLC (also known as "Momentive"). The district court opinion, by Judge Vincent Briccetti, affirms the bankruptcy court's decision that Momentive's senior secured lenders could be "crammed down" at a below-market interest rate, without payment of a make-whole premium. The decision highlights the risks secured lenders face in Chapter 11 proceedings in the Southern District of New York — one of the pre-eminent forums for large commercial restructurings.

Background

Momentive, a private-equity sponsored manufacturer of quartz and silicone products, commenced Chapter 11 cases in the U.S. Bankruptcy Court for the Southern District of New York in April 2013. Its plan of reorganization, filed in June of that year, proposed to equitize over $1.3 billion in second-lien debt and eliminate $380 million in senior subordinated notes. As to its holders of approximately $1.1 billion in first-lien notes and $250 million in 1.5-lien notes (notes junior to the first-lien notes but senior to Momentive's other funded debt), the plan offered a choice: (1) accept the plan and receive payment in full in cash of the face amount of debt, not including any make-whole premium, or (2) reject the plan and receive replacement notes at a cramdown rate, the principal amount of which would reflect the make-whole premium to the extent so determined by the court. Put simply, the senior-lien lenders could either relinquish their make-whole claims and receive payment in cash or pursue their make-whole claims and receive cramdown replacement notes yielding below-market interest.

The senior-lien lenders rejected the plan and objected, arguing that the plan violated the U.S. Bankruptcy Code's requirement of "fair and equitable" treatment by forcing the lenders to accept replacement notes bearing interest rates between 3.6 percent and 4.1 percent — a modest premium over the prevailing seven-year Treasury rate but significantly below prevailing market rates. The senior-lien lenders also argued that the debtors triggered the make-whole provisions of the applicable indentures by effectively refinancing the notes before their stated maturity.

Bankruptcy Court Decision

In an August 26, 2014, bench decision, bankruptcy judge Robert Drain overruled the lenders' objections and confirmed the debtors' plan. Judge Drain held that interest on replacement debt is calculated by selecting an appropriate base rate—such as the prime rate or the treasury rate, depending on the maturity — and adding a modest 1 percent to 3 percent risk premium to account for the possibility that the debtors will not make the required payments. The rate should not, he concluded, confer a profit on the lenders. This approach is colloquially referred to as the "formula" or "prime-plus" approach. Judge Drain concluded that the dispute was controlled by *Till v. SCS Credit Corp.*, a 2004 U.S. Supreme Court decision applying the formula approach to an auto loan in Chapter 13 consumer bankruptcy — a controversial conclusion in light of dicta in the *Till* opinion others have read to imply that the formula approach is inappropriate in Chapter 11 cases.

As to the make-whole dispute, Judge Drain held that no make-whole premium was due because the judge construed the indenture to require a make-whole premium only in connection with a prepayment. Under the indenture, bankruptcy petition accelerated

the indebtedness. The "payment" of the notes under the plan therefore was not a prepayment and thus presumptively did not trigger a prepayment premium. Judge Drain parsed the applicable indentures and found no language clearly rebutting this presumption.

District Court Decision

The district court's May 4 decision affirmed the bankruptcy court in all respects. As Judge Briccetti noted, the statutory touchstone underlying the cramdown dispute is Section 1129(b) of the Bankruptcy Code, which provides, in relevant part, that a plan is fair and equitable to secured creditors if it permits secured creditors to retain their liens and receive "deferred cash payments totaling at least the amount of 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, fully secured creditors can be required to accept a stream of payments over time if the present value of such payments equals the amount of their claim. But what interest rate best reflects the present value of future cash payments in this context?

Judge Briccetti, like Judge Drain, concluded that the formula approach, rather than the efficient-market approach advocated by the lenders, yields the appropriate rate. The lenders' position, he explained, ran contrary to the Supreme Court's *Till* decision and the Second Circuit's earlier decision in *In re Valenti*. Although both cases arose in the Chapter 13 context, their reasoning controlled the case at bar. Specifically, both cases held that market rates are over-compensatory insofar as they confer profit upon the secured lender. The purpose of the cramdown rate, they reasoned, is to discount future cash payments so that they equal the allowed amount of the lender's claim, not to approximate the yield a lender would require to make a new loan to the debtor. Although the *Till* plurality opined in dicta that "in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce," Judge Briccetti concluded that this dicta did not definitively require the efficient-market approach in Chapter 11 cases. To the contrary, he concluded that the secured lenders had offered no persuasive reason why secured creditors should be treated differently in Chapter 11 and Chapter 13 cases.

Judge Briccetti also rebuffed the secured lenders' fallback argument that Judge Drain applied the formula approach incorrectly. The lenders challenged both elements of the formula rate calculation: the selection of the base rate and the determination of the risk premium. As to the base rate, the lenders argued that, to the extent it required the formula approach at all, *Till* required the national prime rate rather than the lower seven-year Treasury rate. As to the risk premium, the lenders asserted that Judge Drain imposed an arbitrary and insufficient 3 percent limit. Judge Briccetti rejected both arguments. *Till* does not require universal application of the prime rate; Judge Drain's adoption of the seven-year Treasury rate — which he concluded was more appropriate for a long-term commercial loan — was reasonable. Judge Drain's computation of the risk premium (2 percent for the first-lien notes and 2.75 percent for the 1.5-lien notes) likewise was "well within the bounds of reasonableness."

On the make-whole dispute, the district court's decision closely tracked Judge Drain's analysis, ultimately arriving at the same outcome. Judge Briccetti's analysis began with the proposition that the payment of a debt upon acceleration is presumptively not a prepayment. A lender that wishes to preserve its right to a prepayment premium upon the acceleration of the debt must unambiguously contract for that result. Parsing the applicable indenture provisions, the district court found no language clearly imposing the make-whole premium upon acceleration. Language in the indentures' acceleration clause calling for the payment of the "premium, if any" upon acceleration was ambiguous in light of the "if any" proviso. Language requiring a make-whole premium in connection with any payment before October 15, 2015, was similarly ambiguous, as that provision lacked express language requiring payment of the make-whole premium even if the October 15, 2015, maturity date were advanced by virtue of the indentures' automatic acceleration clause.

Conclusions

The *Momentive* decision highlights the risks secured lenders face in complex Chapter 11 cases. Coupled with other recent developments, including several decisions significantly curtailing secured creditors' credit bid rights, the *Momentive* decision may suggest a turn toward harsher treatment of secured lenders in bankruptcy. While senior secured lenders will continue to hold the upper hand in many restructuring scenarios, *Momentive* represents a meaningful incremental shift in the balance of power toward debtors and junior creditors.