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Second Circuit Adopts Secured Creditor Cramdown Standard Based on Market Efficiency

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In 2017, the U.S. Court of Appeals for the Second Circuit held in *In re MPM Silicones, LLC* that the appropriate interest rate for replacement notes issued to secured creditors under a "cramdown" Chapter 11 plan must be a market rate if an "efficient market" exists. If no such market exists, however, the formula rate (effectively, the prime rate plus 1-3 percent) must be applied. While the decision settled the question concerning the applicable cramdown interest rate methodology in the Second Circuit, it left unresolved a critical element of that methodology: What constitutes an "efficient market"?

A close reading of *In re MPM* and the precedent upon which it relied reveals that a practical, transaction-based approach should be used in assessing market efficiency rather than an economic theory approach (*e.g.*, the efficient capital market hypothesis).[1]

Chapter 11 'Cramdown'

The Bankruptcy Code provides two paths by which a Chapter 11 plan can be confirmed — consensual or nonconsensual — depending on how creditor classes vote. If a class of creditors rejects a plan, a debtor can still confirm it if it does not "discriminate unfairly, and is fair and equitable" with respect to the dissenting class. In the lexicon of bankruptcy practitioners, this latter confirmation method is colloquially referred to as "cramdown."

Under the Bankruptcy Code, a plan is fair and equitable to a class of secured claim holders if such holders receive deferred cash payments totaling at least the allowed amount of their claims. The central inquiry under this present value calculation is the appropriate interest rate, called the discount rate, to apply to the debtor's deferred cash payments so that the sum of these payments equals the allowed amount of the secured creditor's claim. Despite the discount rate playing such a central role in this calculation, the Bankruptcy Code is silent as to how to determine it, which has resulted in courts developing many different approaches for determining the discount rate in Chapter 11 cases.

MPM Decision

In April 2014, Momentive Performance Materials Inc. (MPM) filed for relief under Chapter 11. Under MPM's Chapter 11 plan, its senior lien noteholders could choose between (1) accepting the plan and receiving full payment in cash, but without any make-whole claim; and (2) rejecting the plan, preserving their right to litigate the make-whole claim and "receiving replacement notes with a present value equal to the Allowed amount of such holder's Claim." The senior lien noteholders rejected the plan, and consequently, MPM sought to confirm its plan by cramming down these dissenting holders using the formula rate. The bankruptcy court held that the formula rate applies, and the district court affirmed, after which the senior lien noteholders appealed.

The Second Circuit disagreed that the formula rate should always apply and held that a two-step approach must be used in determining the appropriate cramdown interest rate in Chapter 11. A market rate should apply in Chapter 11 cases where an efficient market exists; if an efficient market does not exist, the formula rate

[1] This article was adapted from "*Momentive* and the 'Efficient Market': The Cramdown Saga Continues," published in *Norton Annual Survey of Bankruptcy Law*, 2018 ed., with permission from Thomson Reuters.

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applies. Relying heavily on the 2004 U.S. Supreme Court decision *Till v. SCS Credit Corp.*, the court reasoned that this two-step approach best aligns with the Bankruptcy Code and relevant precedent. Ignoring efficient market rates would depart from long-standing precedent directing that the "best way to determine value is exposure to a market." The court observed that where some market valuation may be available, such valuation should be favored over decisions untested by a competitive choice. The Second Circuit ultimately remanded to the bankruptcy court to ascertain if an efficient market exists and, if so, to apply the market rate.

Implications

In re MPM is a significant decision for the secured lending community. A debtor in the Second Circuit — one of the largest forums for corporate bankruptcy cases — now cannot force a secured creditor into below-market paper if an efficient market exists. Notably, the delta between the formula rate and market rate can be substantial. For example, in *In re MPM*, the first-lien noteholders estimated that using a market rate (roughly 5-6+ percent) instead of the formula rate (4.1 percent) would result in them receiving approximately $150 million more in aggregate interest payments.

But the question of what constitutes an efficient market remains unanswered. Should market efficiency be tested in the same manner as it is in the securities law context under Rule 10(b)-5 of the Securities Exchange Act, for which there is a substantial body of case law evaluating market efficiency, or some other method given that the relevant market is arguably original issuance because specific debt is being issued by a specific debtor?

In *In re MPM*, the Second Circuit seems to define an efficient market differently, and substantially more narrowly, than has been assumed in the securities law context. In describing what constitutes an efficient market, the Second Circuit explained that "courts 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 court found that a market is efficient if it "generates an interest rate that is ... acceptable to sophisticated parties dealing at arms-length." These descriptions of efficiency are substantially narrower than the robust, open and transparent trading markets required by courts in the securities law context.

In relying on *Till*, the Second Circuit seems not to be seeking a sea change to Chapter 11 practice. *Till* held that the formula rate should apply for calculating the cramdown interest in Chapter 13. In arriving at this conclusion, *Till* emphasized that the method for determining the appropriate cramdown interest rate should not be complex, costly or outside the bankruptcy court's area of expertise. Moreover, in rejecting various other approaches, *Till* explained that these methods were complicated and imposed significant evidentiary costs, whereas the formula approach involved "a straightforward, familiar, and objective inquiry, and minimize[d] the need for potentially costly additional evidentiary proceedings."

The Second Circuit seemingly adopted a similarly practical, objective approach to determining market efficiency — one consistent with Supreme Court precedent and squarely within the bankruptcy court's bailiwick. In *dicta*, the Second Circuit observed that while MPM obtained offers from only three exit lenders during its bankruptcy case, if the bankruptcy court had given credit to the expert testimony regarding the exit financing available to MPM, that testimony "would have established a market rate." Thus, the Second Circuit implicitly suggested that such facts — obtaining exit financing offers (potentially as few as three) — constitute an efficient market.

The Second Circuit's two-step approach will likely result in lengthy and expensive evidentiary hearings until the lower courts agree on how to assess market efficiency. Recently, the bankruptcy court in MPM conducted a two-day trial on whether an efficient market existed — and if one existed, what should be the market rate. The trial consisted of a classic battle of the experts over how to assess market efficiency.

Although the bankruptcy court has not yet ruled, the judge remarked at the trial that courts applying a market-based approach have done so primarily based on what has happened in the case, as opposed to extensive expert testimony on debt markets and whether the parties were sophisticated and dealing at arm's length. He further observed that a market-based approach would be fairly easy to apply. *In re MPM* and *Till* both teach that just such a straightforward, less expensive and familiar approach should be used in evaluating market efficiency in Chapter 11.

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