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Feature

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Rejecting Market-Based Cramdown Interest Rates, and Making Words Count for Make-Whole Payments

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Editor's Note: *For another perspective on* Momentive Performance*, read the article on p. 38 of the November 2014 issue.*

Since the recent period of low interest rates, many borrowers have attempted to use bankruptcy to refinance their high-interest debt. These attempts sometimes run counter to provisions in the underlying loan documents that require borrowers to pay so-called "make-whole" premiums, which are designed to compensate lenders for the lost interest caused by the early repayment of debt. This has led to increased litigation over the enforceability of make-whole provisions in the bankruptcy context. In a recent decision, the U.S. Bankruptcy Court for the Southern District of New York examined the enforceability of such make-whole provisions when the acceleration of debt is caused by a bankruptcy filing. The same decision also provided guidance on the rate of interest required in a chapter 11 cramdown.

Factual Summary

Momentive Performance Materials and its affiliated debtors filed chapter 11 petitions on April 13, 2014. The debtors' reorganization plan provided oversecured holders of senior first-lien notes and senior intermediate-lien notes with two options: vote to (1) accept the reorganization plan, in which case they would receive payments in full in cash on their claims but without any make-whole premium; or (2) reject the reorganization plan, in which case they would receive replacement lien notes equal to the principal amount of their claims plus interest, and they would retain their right to argue for the make-whole payment. The noteholders voted to reject the reorganization plan, and the debtors moved to cram down the reorganization plan over their objections. At the confirmation hearing, two of the primary issues considered were the proper interest rate to be used in a cramdown and the enforceability of the make-whole.

Normalizing the Cramdown Interest Rate: Removing Market Forces

The noteholders challenged the debtors' proposed interest rate on the replacement notes, suggesting that the rate should be comparable to the rate that "market-based lenders would expect for new notes [of] the same tenor issued by comparable borrowers."[1] However, the reorganization plan did not do this. Instead, it tied the interest rate to the Treasury rate plus a premium to account for the risk of the debtors defaulting on the reorganization plan. Hon. **Robert D. Drain** agreed with the debtors' formulaic method of interest rate calculation — one that was easily reproduced without the need for costly expert testimony and evidentiary hearings.[2]

Section 1129(b) permits a debtor to "cram down" a dissenting secured creditor class and force plan confirmation over their objections as long as the creditors retain their liens securing their claims[3] and receive, on account of their claims, "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 such property."[4] Since the reorganization plan provided

1 *In re MPM Silicones LLC*, Case No. 14-22503-rdd, 2014 Bankr. LEXIS 3926, at *71 (Bankr. S.D.N.Y. Sept. 9, 2014).
2 *Id.* at *75.
3 11 U.S.C. § 1129(b)(2)(A)(i)(I).
4 11 U.S.C. § 1129(b)(2)(A)(i)(II).

for replacement liens, the issue before the court was whether the interest rate on the replacement notes satisfied the present value test in § 1129(b)(2)(A)(i)(II).[5]

The court noted that there are two typical methods for deriving an interest rate for present value purposes. The market-based approach ties the cramdown interest rate to "the rate that the creditor charges for loans of similar character, amount and duration to debtors in the same geographic region."[6] In contrast, the formula approach begins with a riskless rate that is applicable to all obligations and then adjusts it to account for the risks that are unique to the debtor.[7]

Judge Drain held that the formula approach was the appropriate method for setting the interest rate and primarily relied on two cases: *Till v. SCS Credit Corp.*[8] and *GMAC v. Valenti*.[9] Both cases flatly rejected the market-based loan approach in the context of a chapter 13 plan confirmation, holding that this approach is "complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure [that] the debtor's payments have the required present value."[10] *Till* was particularly influenced by the fact that market-based rates inherently capture transaction costs and profits, therefore overcompensating creditors in the bankruptcy context by providing them with the value of an entirely new loan.[11] Judge Drain agreed that the cramdown interest rate should start with a riskless rate that is applicable to all obligations, then increase by 1 to 3 percent to account for risks that might be related to the nature of the collateral security, the terms of the replacement notes, and the duration and feasibility of the reorganization plan.[12]

Judge Drain rejected the noteholders' contention, based on a footnote in *Till*, that if there is an efficient market for financing, then the cramdown rate should equal the market rate of interest.[13] The noteholders pointed to the exit financing obtained by the debtors to fund the cash-out element of the reorganization plan and argued that the exit financing could be viewed as the market rate. However, Judge Drain held that the footnote must be considered in the context of the sentence, and such context "clearly rejects the lender's right to be rendered indifferent to [a] cramdown or ... compensated for cramdown purposes on a market basis."[14] While the noteholders argued that the exit-financing rate could be viewed as a proxy for the *Till* formula rate, Judge Drain ultimately rejected that premise because he refused to assume — and the noteholders failed to demonstrate — that the exit-financing rates did not incorporate a profit and transaction cost component.

Enforceability of Make-Whole Provisions

Make-whole provisions provide yield protections in the event of a loan's early repayment. In the typical make-whole scenario, a borrower repaying a debt prior to maturity is required to pay a premium for the early repayment, which provides benefits for both the lender and borrower. From the lender's perspective, it is able to lock in a guaranteed rate of return. From the borrower's perspective, it gains the freedom to repay its debt prior to the maturity date and often obtains the loan at a lower interest rate.

In the *Momentive Performance* case, the noteholders argued that they were entitled to make-whole payments under their respective indentures and notes based on the debtors' issuance of the replacement notes. The debtors argued that the noteholders had waived their rights to a make-whole payment based on the automatic acceleration provisions of the indentures. The court's decision is instructive in that it highlights the importance of setting forth in clear and unambiguous terms the lender's right to a make-whole payment in the case of an acceleration of the debt.

Judge Drain set forth a two-step approach for considering the allowance of a claim in bankruptcy. First, the court considered whether the claim would be valid under applicable nonbankruptcy law. Second, the court considered whether there was any limitation on, or provision for disallowance of, the claim under the Bankruptcy Code.[15]

The court noted that it was "well settled" under New York law[16] that parties may waive New York's "perfect tender" rule to allow the borrower to prepay the debt in return for consideration to be paid to the lender compensating it for the cessation of interest payments.[17] However, the court also noted that New York law provides that a lender may forfeit the right to compensation for prepayment if the lender accelerates the balance of the loan.[18] In order to avoid such a forfeiture, there must be a "clear and unambiguous clause call[ing] for the payment of a prepayment premium or make-whole, even in the event of acceleration of, or the establishment of a new maturity date for, the debt."[19] Therefore, the question in *Momentive Performance* became whether there was clear and unambiguous language in the indentures and notes that would allow the noteholders to avoid the forfeiture of their rights to the make-whole.

Unfortunately for the noteholders, the court found no such language. Instead, the court found that the parties had negotiated for the automatic acceleration of the debt upon the debtors' bankruptcy filing. Specifically, section 6.02 of the indentures provided that in the event of a bankruptcy filing, "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 Holders."[20] Based on this language, the court held that the parties had provided for an automatic acceleration of the debt upon filing for bankruptcy. Under the court's reasoning, the maturity date of the notes had therefore been contractually advanced and was the functional equivalent of an acceleration by the noteholders.[21] Since there was no "clear and unambiguous" language providing for the make-whole notwithstanding the accelerated

5 *In re MPM Silicones*, 2014 Bankr. LEXIS 3926, at *70-71.
6 *Id.* at *73 (citing *GMAC v. Valenti (In re Valenti)*,105 F.3d 55, 63 (2d Cir. 1997)).
7 *Id.* at *76.
8 541 U.S. 465 (2004).
9 105 F.3d 55 (2d Cir. 1997).
10 *In re MPM Silcones*, 2014 Bankr. LEXIS 3926, at *73-74 (quoting *Till*, 541 U.S. at 477; citing *Valenti*, 105 F.3d at 63-64)).
11 *Id.*
12 *Id.* at *76-77 (citing *Till*, 541 U.S. at 479).
13 *See Till*, 541 U.S. at 476 n.14.
14 *In re MPM Silcones*, 2014 Bankr. LEXIS 3926, at *79-80.
15 *Id.* at *35.
16 The indentures and notes were governed by New York law. *Id.* at *7.
17 *Id.* at *35.
18 *Id.* at *36.
19 *Id.* at *37.
20 *Id.* at *37-38. The notes contained substantively identical acceleration provisions. *Id.*
21 *Id.* at *40-41. *See also In re AMR Corp.*, 730 F.3d 88, 101 (2d Cir. 2103) (automatic-acceleration provision operates by choice of indenture trustee and issuer/debtor such that automatic acceleration is not voluntary on issuer's part because it is an enforceable covenant).

debt, the court held that the noteholders had forfeited their rights to make-whole payments.[22]

The court then provided what can be considered a roadmap for future indentures and notes. The court opined that what would have been legally sufficient to preserve the noteholders' rights to the make-whole would either be (1) an explicit recognition that the make-whole would be payable notwithstanding the acceleration of the loan, or (2) a provision that required the borrower to pay a make-whole whenever the debt is repaid prior to its original maturity date.[23] Since such language was missing from both the indentures and the notes, the court held that the noteholders had waived their claims to the make-whole.

Tactical Changes to Acceptance or Rejection of a Plan Are Not Permitted

Following the court's ruling, the trading prices for the replacement notes substantially decreased. In response, the noteholders filed motions seeking to change their plan vote from rejection to acceptance. By doing so, the noteholders would have been able to take advantage of the reorganization plan's provision that provided full cash payment on account of the noteholders' secured claims (without premiums) in exchange for their acceptance of the reorganization plan.[24] Judge Drain denied the noteholders' motions, holding that a tactical change in voting based on newly discovered information was inappropriate. The "fish-or-cut-bait" provision in the reorganization plan was expressly designed to avoid the expense and uncertainty of a contested cramdown hearing.[25] As such, changing their vote after the cramdown hearing would be inappropriate and encourage opportunistic behavior that is contrary to the otherwise-orderly reorganization process.[26]

Conclusion

There are at least three important takeaways from the *Momentive Performance* decision. First, the court's comprehensive analysis of *Till* and *Valenti* in the context of cramdown interest rates under § 1129(b)(2)(A)(i)(II) presents debtors with guidance in selecting cramdown interest rates and dramatically lessens the evidentiary requirement for confirmation. Under *Momentive Performance*, the only evidentiary requirements are those that are necessary to determine how much of a risk premium to add based on the circumstances of the debtor's estate, the nature of the security, and the duration and feasibility of the reorganization plan. The decision puts the burden squarely on the objecting creditor(s) to demonstrate the uncertainty of plan feasibility and the risks facing the company after it emerges from chapter 11 since the greater the uncertainty and risks, the higher the interest rate should be.

Second, the court's decision underscores the need for lenders to ensure that the underlying loan documents explicitly set forth in clear and unambiguous terms the situations in which make-whole payments will be due. Specific consideration should be given to the language, which Judge Drain opined would be legally sufficient to overcome the waiver of the make-whole upon acceleration of the debt. While it is too late to add such language to existing loan agreements, if the borrowers under those loan agreements find themselves in financial distress and request forbearance or other relief, a prudent lender should insist that the underlying loan documents be amended to include the clear and unambiguous language that will be required to preserve the make-whole.

Third, the post-confirmation proceedings case should serve as a reminder to creditors that they should take fish-or-cut-bait provisions in proposed reorganization plans very seriously. Such provisions are designed to avoid the expense and uncertainty of a cramdown hearing, and it is certainly questionable whether courts will permit a creditor to tactically change its vote after the fact, at least without the plan proponent's consent. abi

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22 *Id.* at *40.

23 *Id.* at *43.

24 *In re MPM Silicones LLC*, Case No. 14-22503-rdd, 2014 Bankr. LEXIS 4062, at *2-3 (Bankr. S.D.N.Y. Sept. 17, 2014).

25 *Id.* at *9 (citing *In re Drexel Burnham Lambert Grp.*, 138 B.R. 714, 717 (Bankr. S.D.N.Y. 1992); *In re Adelphia Commc'ns Corp.*, 368 B.R. 140, 275 (Bankr. S.D.N.Y. 2007); *In re Zenith Elec. Corp.*, 241 B.R. 92, 105 (Bankr. D. Del. 1999)).

26 *Id.* at *11 (quoting *In re J.C. Householder Land Trust #1*, 502 B.R. 602, 607-08 (Bankr. M.D. Fla. 2013)).