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LOSING *MOMENTIVE*: A ROADMAP TO HIGHER CRAMDOWN INTEREST RATES

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I. Introduction

There has been a lot of press regarding the lengthy *Momentive*[1], bench ruling delivered in late 2014.[2] In *Momentive*, the Bankruptcy Court for the Southern District of New York held that debtors could satisfy the "cramdown" requirements of section 1129(b) of the Bankruptcy Code by distributing to secured creditors replacement notes paying below-market interest rates based on small margins.[3] Several months later, the Ninth Circuit Bankruptcy Appellate Panel ("BAP") issued an unpublished decision in which it took a more nuanced approach to cramdown interest rate calculation.[4] Instead of identifying a defined range for acceptable margins, as was the case in *Momentive*, the Ninth Circuit BAP concluded that creditors should shoulder the evidentiary burden to

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[1] In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 at *34 (Bankr. S.D.N.Y. Sept. 9, 2014). MPM stands for "Momentive Performance Materials", and we refer to the case as "Momentive" throughout.

[2] *See e.g.*, Matt Wirz, *Momentive Ruling Shakes Up Debt Markets*, MONEYBEAT (Aug. 28, 2014), http://blogs.wsj.com/moneybeat/2014/08/28/momentive-ruling-shakes-up-debt-markets/; Adam C. Harris & Karen S. Park, *Bankruptcy Court Approves Non-Market Cramdown Rate on Momentive Secured Creditors*, HARVARD LAW SCHOOL BANKRUPTCY ROUNDTABLE (Mar. 17, 2015), http://blogs.law.harvard.edu/bankruptcyroundtable/2015/03/17/bankruptcy-court-approves-non-market-cramdown-rate-on-momentive-secured-creditors/; Mark I. Bane, *Bankruptcy Court Holds Secured Creditors Can Be "Crammed Down" With Below-Market Replacement Notes*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION (Sept. 6, 2014), http://corpgov.law.harvard.edu/2014/09/06/bankruptcy-court-holds-secured-creditors-can-be-crammed-down-with-below-market-replacement-notes/; Alan Zimmerman, *Bankruptcy: In Cram-Down Fight, Momentive Loses the Battle, but Wins the War*, HIGHYIELDBOND.COM (Aug. 27, 2014, 10:24 AM), http://www.highyieldbond.com/in-cram-down-fight-momentive-loses-the-battle-but-wins-the-war/.

[3] In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

[4] In re Dunlap Oil Co., Inc., No. AZ-14-1172-JuKiD, 2014 WL 6883069 (B.A.P. 9th Cir. Dec. 5, 2014).

prove the risk factors used to determine the appropriate cramdown rate.[5] In the wake of *Momentive,* the Ninth Circuit BAP has offered undersecured creditors a roadmap to higher cramdown interest rates under the right circumstances.[6]

II. *Till* Sets the Cramdown Interest Stage

A chapter 11 plan of reorganization may be confirmed without the consent of an impaired class of secured creditors if the plan satisfies the conditions set out in section 1129(b) of the Bankruptcy Code.[7] Such conditions include a requirement that the plan be fair and equitable with respect to the objecting class, which, in the case of secured creditors, is satisfied when creditors in the class retain the lien securing their claims and receive deferred cash payments with a present value at least equal to the value of their secured claims.[8] The present value is determined as of the effective date of the plan, and the deferred cash payments must consist of an appropriate cramdown interest rate and amortization of principal.[9]

The Bankruptcy Code is silent as to how bankruptcy courts should calculate the appropriate cramdown interest rate.[10] In the absence of a clear statutory directive, "[c]ourts have used a wide variety of different rates as benchmarks in computing the appropriate interest rate (or discount rate as it is frequently termed) for the specific risk level in their cases."[11] Among these methods are the formula rate, the coerced loan rate, the presumptive contract rate, and the cost of funds rate.[12]

Till v. SCS Credit Corp. is the leading case on cramdown interest rates. Under *Till*, the United States Supreme Court eschewed a market interest rate and held instead that the cramdown rate should be determined by a “formula” approach: taking the national prime rate and adjusting it by a margin that takes into consideration "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan."[13] However, the Supreme Court noted specifically that, in a chapter 13 case, "there is no free market of willing cramdown lenders," and that "the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession."[14] Nevertheless, since *Till*, many courts have been persuaded by *Till*'s

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[5] *Id.* at *20.

[6] *See Dunlap Oil*, 2014 WL 6883069.

[7] *See* 11 U.S.C. § 1129(b) (2010).

[8] *See* 11 U.S.C. § 1129(b)(1); In re Dynamic Brokers, Inc., 293 B.R. 489, 499 (B.A.P. 9th Cir. 2003); In re Arnold & Baker Farms, 85 F.3d 1415, 1420 (9th Cir. 1996).

[9] *See* Matter of Briscoe Enterprises, Ltd., II, 994 F.2d 1160, 1169 (5th Cir. 1993).

[10] *See* In re Am. HomePatient, Inc., 420 F.3d 559, 565 (6th Cir. 2005).

[11] *Briscoe*, 994 F.2d at 1169.

[12] *See* Till v. SCS Credit Corp., 541 U.S. 465, 473 (2004) (discussing methods of calculating cramdown interest rates in analogous chapter 13 cases).

[13] *Id.* at 479.

[14] *Id.* at 476 n.14.

reasoning and have adopted its formula approach in cases under chapters 13 and 11.[15]

III. Along Comes *Momentive*

In 2012, Momentive Performance Materials Inc. and its affiliates (collectively, "Momentive") issued $1.1 billion of first-lien notes and $250 million of "1.5-lien" notes due 2020 under indentures with substantially similar terms governed by New York law. In April 2014, Momentive filed a chapter 11 petition and subsequently proposed a death-trap plan to pay noteholders either (i) in full in cash, without a make-whole premium, if the noteholders voted in favor of the plan, or (ii) seven-year replacement notes in the amount of their allowed claims at a below-market rate and the right to litigate their make-whole claims, if they did not vote in favor of the plan.[16] The noteholders did not vote in favor of the plan, and they objected to confirmation of the plan on grounds that the treatment of their claims was not fair and reasonable under applicable cramdown standards.[17]

Because secured noteholders rejected the debtors' proposed plan, the debtors were required to satisfy the cramdown requirements of section 1129(b)(2) of the Bankruptcy Code, as described above.[18] At issue was whether the secured noteholders would receive deferred cash payments totaling at least the value of the secured portion of their claim as of the effective date of the plan under section 1129(b)(2) of the Bankruptcy Code and, more specifically, whether the cramdown rate on the replacement notes to be issued under the plan was sufficient.[19] The debtors argued that their plan provided sufficient present value to satisfy the cramdown requirements standard enumerated in *Till* and by the Second Circuit in *In re Valenti*, 105 F.3d 55 (2d Cir. 1997), in which the respective courts applied a "formula" approach under an analogous chapter 13 provision to determine a

[15] *See* In re Texas Grand Prairie Hotel Realty, L.L.C., 710 F.3d 324, 331 (5th Cir. 2013) (discussing the persuasive, yet non-binding, nature of the "splintered" *Till* decision); In re Blanton, No. 10-60160, 2010 WL 4503188 at *2 (Bankr. N.D. Ohio Oct. 29, 2010) (critiquing the precedential value of *Till* and its formula approach); *see also, e.g.*, In re Toso, No. BAP EC-05-1290, 2007 WL 7540985 at *8–9 (B.A.P. 9th Cir. Jan. 10, 2007); Mercury Capital Corp. v. Milford Conn. Assocs., L.P., 354 B.R. 1, 12 (D. Conn. 2006). *But see, e.g.*, Am. HomePatient, 420 F.3d at 566–68 (refusing to fully adopt the *Till* formula approach in a chapter 11 case).

[16] Voluntary Petition, In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014); Joint Chapter 11 Plan of Reorganization for Momentive Performance Materials Inc. and Its Affiliated Debtors, In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

[17] Cramdown Objection of Wilmington Trust, National Association, as Indenture Trustee, to Confirmation of Debtors' Proposed Joint Chapter 11 Plan of Reorganization, In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014); Objection of Wilmington Trust, National Association, as Indenture Trustee, to Confirmation of Debtors' Proposed Joint Chapter 11 Plan of Reorganization, In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).

[18] *See* 11 U.S.C. § 1129(b) (2010).

[19] In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335, at *23 (Bankr. S.D.N.Y. Sept. 9, 2014).

proper interest rate by taking a risk-free base rate, such as the prime rate or the Treasury rate, and adding a margin to account for debtor-specific risk of non-payment.[20] The secured noteholders argued that (i) the formula approach was only relevant in the absence of a clear market rate, and (ii) the higher rate in the debtors' exit financing commitment clearly evidenced a market rate.[21]

In August 2014, the Bankruptcy Court for the Southern District of New York issued a lengthy bench ruling, which was later corrected and re-issued in September 2014.[22] The Bankruptcy Court rejected market-based approaches (such as the "coerced loan" approach) used by other courts, whereby the cramdown interest rate is determined based on the rates for similar loans in similar circumstances, the cost of funds, and other conditions, assuming a market exists.[23] Instead, the Bankruptcy Court held, *inter alia*, that the debtors could cram down their plan of reorganization on the secured lenders under section 1129(b)(2)(A)(i) of the Bankruptcy Code by providing them with replacement notes paying below-market interest rates, limiting the interest rate determined by the formula approach to the prime rate plus a margin of 1 to 3 percent depending on the risk of nonpayment.[24] The Bankruptcy Court reasoned that the formula approach meets the objective of section 1129(b)(2)(A)(i)(II) by putting the creditor in the same economic position as it would have been in if it immediately received the value of its allowed claim[25]—and that such value should not include any degree of profit.[26] The Bankruptcy Court ultimately found that (i) the elements of profit and transaction cost considered in the market approach are not to be considered in calculating present value with respect to cramdown rates, and, moreover, such market approach requires costly evidentiary hearings that involve issues unfamiliar to bankruptcy judges; and (ii) the formula approach should start with a riskless rate and be adjusted upward (1 to 3 percent) for debtor-specific risks (i.e., "based on the circumstances of the debtor's estate, the nature of the collateral security and the terms of the cramdown note itself, and the duration and feasibility of the plan").[27] The Bankruptcy Court reiterated that application of an appropriate risk premium is not a means to achieve a market rate, finding that up to 1 to 3 percent per annum is appropriate in the absence of "extreme risk."[28]

In determining the appropriate risk premium for the Momentive noteholders, the

[20] *Id.* at *24-*25.
[21] *Id.* at *24, *25.
[22] In re MPM Silicones, LLC, No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014).
[23] *See id.* at *25.
[24] *Id.* at *29.
[25] The Bankruptcy Court found no reason to distinguish between the statutory objectives of analogous provisions regarding plan confirmation under chapters 13 and 11 and therefore found *Valenti*'s conclusion that the formula approach satisfies section 1325(a)(5)(B)(ii) wholly supportive of the argument that it likewise satisfies the requirement for plan confirmation under section 1129(b)(2)(A)(i)(II). *Id.* at *25.
[26] *Id.*.
[27] *Id.* at *26.
[28] *See id.* at *31.

Bankruptcy Court looked to the market testimony of the debtors and the parties' investment bankers.[29] The Bankruptcy Court relied almost exclusively on the debtors' financials, projections, and budgets to conclude that the noteholders' investment bankers engaged in no independent analysis and failed to engage in a rigorous testing of the debtors' projections.[30] The Bankruptcy Court found that repayment was very likely given a healthy asset coverage ratio under the plan (closer to 50 percent than 75 percent), a much-reduced total debt leverage (with debt reduced from $4.4 billion to $1.3 billion), and a committed $600 million equity investment.[31] Accordingly, the Bankruptcy Court concluded that the risk of non-payment (as opposed to the risk of default) was relatively low and that the 1.5 and 2 percent risk premiums, for the first and 1.5-lien replacement notes established by the debtors under the plan, were appropriate.[32] The Bankruptcy Court disagreed only with the debtors' selection of the Treasury rate as the base rate because the Treasury rate assumes virtually no risk of payment by the United States—whereas a rate closer to the prime rate more accurately accounts for the risk of the debtors' performance.[33]

The decision in *Momentive* provides both debtors and secured creditors clear guidance as to how Judge Drain views the calculation of the appropriate interest rate in a secured creditor cramdown situation. While the result was disappointing to secured creditors, the decision bolsters the body of law applying the *Till* formula approach.

IV. *Dunlap Oil* to the Rescue?

Creditors winced after reading the *Momentive* decision's interpretation of the *Till* cramdown rate formula, but they may take a little comfort in the fact that other courts are not strictly limiting the maximum risk margin applied in the formula approach to only 3 percent. In a recent decision, the Ninth Circuit BAP held that the bankruptcy court below did not err in applying a 1.75 percent margin to the 3.25 percent prime rate.[34] Although the secured creditor appellant argued that the rate was still unreasonably low, the Ninth Circuit BAP did not identify a percentage to serve as a cap in all cases, as Judge Drain did in dicta in *Momentive*.[35] Instead, the Ninth Circuit BAP emphasized *Till*'s language in placing the burden on secured creditors to submit evidence to prove that the risks under a particular plan warrant a higher cramdown interest rate: "[S]tarting from a concededly low estimate and adjusting upward places the evidentiary burden squarely on creditors, who are likely to have readier access to any information absent from the debtor's filing . .

[29] *See id.* at *30.
[30] *Id.*
[31] *Id.* at *30–31.
[32] *Id.* at *31.
[33] *Id.*
[34] In re Dunlap Oil Co., Inc., No. AZ-14-1172-JuKiD, 2014 WL 6883069, at *20 (B.A.P. 9th Cir. Dec. 5, 2014).
[35] *Id.*

. . ."[36]

In *In re Dunlap Oil Co., Inc.*, the secured creditors argued that the only evidence on the record that the risk factors required a 4 percent adjustment to the prime rate was testimony from the debtor's financial consultant.[37] While not eliminating the possibility of such a higher margin, the Ninth Circuit BAP held that the burden of proof rests squarely on the creditors to provide such evidence and that the bankruptcy court had not abused its discretion in selecting a lower rate, noting that the bankruptcy court had properly considered the feasibility of the plan, the market conditions, and the absence of evidence that the collateral would decline in value over the term of the plan.[38]

Whereas *Momentive*'s approach to the *Till* rate limited the applicable cramdown rate, *Dunlap Oil* illustrates adherence to precedent in allowing the facts and circumstances in each case to dictate the rate. The flexibility of *Till* and *Dunlap Oil* grants secured creditors their day in court instead of foreclosing higher rates where they might be warranted. Nonetheless, that day in court—and the evidence it requires—can have a significant cost. Without clear evidence of an established market for the secured claim in question, evidence of comparable rates under similar circumstances and the likelihood of nonpayment in each case may not be readily available, apart from evidence created by advisors of the debtor or its creditors; accordingly, the dispute as to the appropriate rate may be costly. To avoid indecision in the absence of probative evidence, a court may consider eschewing the flexibility of *Till*'s formula approach, as followed by *Dunlap Oil*, in favor of a more rigid standard. However, such rigidity should result in judicial economies, e.g., where costly, time-consuming analyses consistently reach the same conclusion. Although it is unlikely that the market rate and risk of non-payment would consistently be the same in wholly different circumstances, the United States Bankruptcy Courts for the Northern and Southern Districts of Mississippi issued a standing order setting the current presumptive *Till* rate at 5.0 percent.[39] A presumptive rate is particularly useful where evidence is lacking and a rate must still be set, as long as the presumptive rate remains only a presumption, rebuttable by contrary evidence. But a fixed interest cap used in *Momentive* offers neither presumption nor efficiency. Enforcing a cap still requires the court to consider evidence in setting the cramdown rate—it merely limits the

[36] *Id.* (quoting Till v. SCS Credit Corp., 541 U.S. 465, 479 (2004)); *see also* In re Tapang, No. 11-59479-ASW, 2014 WL 7212959, at *2 (Bankr. N.D. Ca. Dec. 17, 2014) (likewise concluding that the creditors—not the debtor—bear the burden of proof on the issue of the appropriate cramdown interest rate under chapter 11).

[37] *Dunlap Oil*, at *20; *see also* In re Chardon, LLC, 519 B.R. 211, 221 (Bankr. N.D. Ill. 2014) (The court there was forced to rely on the debtor's financial advisor, who was not "a particularly compelling witness," in the absence of any evidence of a market rate for debtor-in-possession financing, the current prime rate, or an appropriate risk adjustment).

[38] *Dunlap Oil*, at *20.

[39] *See* In re Fortenberry, No. 14-50768, 2014 WL 7407515, at *5 (Bankr. S.D. Miss. Dec. 30, 2014) (examining cramdown interest rates in the chapter 13 context).

effect of such evidence, regardless of its probative value. Therefore, it is encouraging that *Momentive*'s establishment of a maximum cramdown rate threshold remains an isolated, case-specific approach that, to date, has failed to gather momentum.

V. Conclusion

While the *Momentive* decision sent ripples throughout the lending market,[40] its application is limited by the facts of the case. Moreover, while other courts may yet find its reasoning persuasive, the establishment of a judicial cramdown interest rate cap is not gaining widespread traction. As explained above, the Ninth Circuit BAP, in a post-*Momentive* decision, eschewed a clearly defined range for acceptable margins and focused instead on the evidentiary burden creditors have to overcome to prove that higher risks warrant a higher interest rate. Such a "proof-of-risk" approach requires a probative inquiry without foreclosing appropriately higher rates where greater risk exists.

[40] *See, e.g.*, Matt Wirz, *Momentive Ruling Shakes Up Debt Markets*, MONEYBEAT (Aug. 28, 2014), http://blogs.wsj.com/moneybeat/2014/08/28/momentive-ruling-shakes-up-debt-markets/.