CT Bankruptcy Beat
Legal Developments in Restructuring and Creditors' Rights

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Decision Approves Cramdown of Secured Creditors in Chapter 11 With Sub-Market Interest Rate And Disallows Lender's Make-Whole Premium

Posted by Irve J. Goldman
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On May 4, 2015, the U.S. District Court for the Southern District of New York affirmed the controversial and widely discussed decision of the Bankruptcy Court in *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) (Drain, J.), better known as the *Momentive* decision,[1] which addressed the cramdown rate of interest in a Chapter 11 case and whether the voluntary filing of a Chapter 11 case resulted in a secured lender forfeiting its right to payment of a make-whole premium.[2]

In the cramdown attempted in *Momentive*, the secured creditors were given replacement notes for their debt carrying a seven-year maturity and bearing interest at the Treasury bill rate plus a risk premium. A cramdown plan of this type requires that the secured creditor receive a stream of payments over time which, when discounted back to present value, will equal the total secured claim. The present value requirement is what requires interest on the notes, but the Bankruptcy Code does not specify the rate.

The secured creditors in *Momentive* argued for a market rate of interest based on what the market would require for a new loan to a borrower in the Debtors' circumstances, which is known as the "forced loan" approach. The Debtors, on the other hand, urged the Court to approve their much lower interest rate, which was based on a risk-free rate plus a risk premium – known as the "formula approach."

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The “formula approach,” which was endorsed by the U.S. Supreme Court in *Till v. SCS CreditCorp.*, 541 U.S. 465 (2004), as the proper cramdown rate for consumer debtors in Chapter 13 cases, takes a risk-free rate and adds to it a risk premium to account for the risk of nonpayment in the particular case. The *Till* decision instructed that in general, the risk adjustment should be between 1 and 3 percent, although the Bankruptcy Court and District Court in *Momentive* stated that it could be increased above 3 percent for “extreme risks.” The famous footnote 14 in *Till*, however, hinted that a different calculation of the cramdown interest rate might be required for Chapter 11 cases if there were determined to be an efficient market for Chapter 11 financing. This footnote was the basis upon which the secured creditors in *Momentive* argued for a market rate of interest.

As affirmed by the District Court, the Bankruptcy Court approved the use of a formula approach which computed the interest rate on the notes by first taking the 7-year Treasury bill rate as the risk-free base rate and then adding to it a risk premium of 2 percent for one set of secured creditors and 2.75 percent for a second set of secured creditors. The efficient market or “forced loan” approach was rejected because any market rate would include a component for profit and transaction costs to the lender. This was viewed as inconsistent with the present-value function of the cramdown interest rate, which is meant to “put the creditor in the same economic position that it would have been in had it received the value of its claim immediately. The purpose is not to put the creditor in the same position it would have been in had it arranged a ‘new’ loan.” (*Momentive* District Court Mem. Decision at 17-18) (quoting *In re Valenti*, 105 F.3d 55, 63 (2d Cir. 1997)).

The Supreme Court in *Till*, however, used the national prime rate as the risk-free rate and then added on to it a risk premium, whereas *Momentive* started with a much lower risk-free rate by using the Treasury bill rate. Both the Bankruptcy Court and District Court in *Momentive* reasoned that the T-Bill rate could be used instead because the prime rate may be “a more appropriate rate for consumers,” and because *Till* does not require a bankruptcy court to choose the national prime rate as the risk-free base. To compensate for the use of the lower base rate, the Bankruptcy Court added .5 percent and .75 percent, respectively, to the replacement notes as an additional risk premium.

The secured creditors suffered a second loss when they were denied a so-called “make-whole” premium that was required to be paid under their loan documents upon an early redemption or payment of their debt. Such a premium, in general, is an extra payment that is required when a loan is paid off early, and is intended to compensate a secured lender for the loss of future interest it would suffer by the early payoff and a reinvestment of the payment proceeds at a lower interest rate.

The denial of the make-whole premium was based entirely on an interpretation of the loan documents, which made the filing of a voluntary Chapter 11 case an event of default that automatically accelerated the entire debt. The loan provision at issue stated that the accelerated debt would consist of “the principal of, premium,

if any, and interest on all the Notes.” (emphasis added).

Both the Bankruptcy Court and District Court cited the familiar rule that an acceleration of the debt advances the maturity date of the loan, so that any subsequent payment by definition cannot be a prepayment entitling the lender to a make-whole premium, except if there is “clear and ambiguous clause…[that] calls for payment of the prepayment premium.” The bottom line of the *Momentive* decisions on this issue was that neither the Bankruptcy Court nor the District Court read the pertinent loan provision as clearly and unambiguously providing for payment of the make-whole premium on acceleration by its use of the words, “premium, if any.” Thus, on this issue, the decisions are more of a lesson on future drafting for secured lenders.

[1] Momentive Performance Materials Inc. was one of a number of affiliates of the principal debtor, MPM Silcones, LLC, and thus, the decision became known as the *Momentive* decision.

[2] The *Momentive* decision also dealt in large part with an issue of whether the Debtor’s plan of reorganization could be considered “fair and equitable,” and therefore, forced upon the holders of certain subordinated notes over their objection, when they were receiving nothing under the plan while a class of Second Lien Noteholders that was arguably junior to the subordinate noteholders was to receive substantial consideration under the plan. That aspect of the decision, however, was for the most part based on the unique and highly specialized contractual provisions that were at issue in the case.