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The United States District Court for the Southern District of New York Upholds Rulings With Respect to Subordination, Cramdown and the Make-Whole Dispute

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In a memorandum decision dated May 4, 2015, Judge Vincent L. Briccetti of the United States District Court for the Southern District of New York affirmed the September 2014 decision of Judge Robert D. Drain of the United States Bankruptcy Court for the Southern District of New York, confirming the joint plans of reorganization (the "Plan") in the Chapter 11 cases of *MPM Silicones LLC* and its affiliates ("Momentive"). Appeals were taken on three separate parts of Judge Drain's confirmation decision, each of which ultimately was affirmed by the district court:

(i) the language in the indenture for Momentive's subordinated unsecured notes (the "Subordinated Notes") that carved out from the definition of "Senior Indebtedness" any debt that by its terms was junior to any other debt in any respect did not prevent Momentive's second lien notes (the "Second Lien Notes"), which were subject to subordinated liens relative to Momentive's first lien notes (the "Senior Lien Notes"), from being treated as Senior Indebtedness relative to the Subordinated Notes;

(ii) the so-called "Till" formulaic interest rate, rather than a market-based interest rate, could be applied to cramdown paper being provided to holders of Senior Lien Notes; and

(iii) the Senior Lien Notes were not entitled to a make-whole payment.

Background

Momentive incurred substantial debt obligations pursuant to various note indentures. The indenture for the Subordinated Notes provided that the notes were subordinated in right of payment to the prior payment in full of all existing and future "Senior Indebtedness" (a term

that was defined to exclude "any Indebtedness or obligation of the Company…that by its terms is subordinate or junior in any respect to any other Indebtedness or obligation of the Company…"). The Second Lien Notes originally were unsecured at the time of their issuance, but contained a springing lien that ultimately gave them a lien junior to the lien of the Senior Lien Notes. The Senior Lien Notes and the Second Lien Notes were secured by the same collateral (the "Common Collateral"). An intercreditor agreement provided that the Second Lien Notes were subordinated to the Senior Lien Notes with respect to their position in the Common Collateral.

The indenture for the Senior Lien Notes provided for the payment of a make-whole premium if the notes were redeemed prior to a date certain (October 15, 2015). The indenture also contained a provision for the automatic acceleration of the principal, premium, if any, and interest on the notes upon a default triggered by a bankruptcy filing.

The Plan did not provide for any distribution to holders of Subordinated Notes. With respect to the Senior Lien Notes, the Plan provided that if the class voted in favor of the Plan, all outstanding principal and accrued interest would be paid to each holder in cash on the effective date; however, no make-whole premium would be allowed or payable. The Plan, however, contained a so-called "deathtrap" provision, under which if the Senior Lien Note class rejected the Plan, holders would receive replacement notes with a present value equal to the allowed amount of such holders' claims, which potentially could include a make-whole premium (to the extent the bankruptcy court allowed it). The holders of Senior Lien Notes ultimately voted against the Plan, choosing instead to continue to pursue through litigation their entitlement to the make-whole premium.

Because the Second Lien Notes Constitute Senior Indebtedness, the Fact That Subordinated Noteholders Will Not Receive Distributions Does Not Violate the Bankruptcy Code

Holders of Subordinated Notes argued that the Plan violated the Bankruptcy Code by denying them any recovery while providing a distribution to the holders of Second Lien Notes. Specifically, the holders of Subordinated Notes argued that according to the plain language of the indenture, the Second Lien Notes, which were secured by a junior lien, were not Senior Indebtedness, since by virtue of the lien subordination, they were subordinate or junior *in any respect* to other indebtedness of Momentive.

The district court, however, agreed with the bankruptcy court that the indenture excludes *payment* rather than *lien* subordination from the definition of Senior Indebtedness.[1] Looking to New York contract law, the district court found that because the base definition of Senior Indebtedness excluded debt that was subordinated in right of payment, the six provisos that followed (including the proviso that excluded "any Indebtedness or obligation of the Company…that by its terms is subordinate or junior in any respect to any other Indebtedness or obligation of the Company…") only could be read as excluding indebtedness subject to payment (as opposed to lien) subordination. The district court, in affirming the bankruptcy court's conclusion, found that a contrary reading would result in the "in any respect" clause subsuming the reference to subordination in the right of payment contained in the base definition, thus rendering the base definition

[1] The district court distinguished payment (or debt) subordination, which entitles the senior creditor to full satisfaction of its debt before the subordinated creditor receives payment, from lien subordination, where the priority of the lien of the subordinated party is demoted below that of another secured creditor (in other words, the recourse of the subordinated party to the collateral is delayed until satisfaction of the other party's claim from the collateral).

superfluous. Additionally, it was significant that the so-called anti-layering provision[2] in the indenture for the Subordinated Notes did not prevent the incurrence of the Second Lien Notes.

The Cramdown Interest Rate Applied by the Bankruptcy Court is Appropriate

The trustee for holders of Senior Lien Notes argued that the Plan violated the fair and equitable requirement in section 1129(b) of the Bankruptcy Code[3] by using the formula approach,[4] as opposed to the efficient market approach,[5] to calculate the appropriate cramdown interest rate. The district court, however, found that the formula approach was appropriate, applying much of the reasoning that the Supreme Court employed in adopting the approach identified in *Till*.[6] In that case, the Supreme Court rejected the efficient market approach because it "…aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value."[7] The district court also cited the decision of the United States Court of Appeals for the Second Circuit in *Valenti* (a pre-*Till* decision) for the proposition that the Bankruptcy Code does not intend to put creditors in the same position they would have been in had they arranged a new loan, because a new loan would involve a built-in profit that would not be appropriate for someone who involuntarily received cramdown paper pursuant to a Chapter 11 plan.[8] Finally, the district court found that the risk premiums chosen by the bankruptcy court were "well within the bounds of reasonableness" and would not be adjusted.

Holders of Senior Lien Notes Were Not Entitled to a Make-Whole Payment

The district court also agreed with the bankruptcy court that the holders of Senior Lien Notes were not entitled to a make-whole premium as a result of the acceleration of their debt.

The indentures provided that debt acceleration was automatic in the case of a voluntary bankruptcy filing. Under New York law, because such acceleration advances the maturity date of the loan, any subsequent payment is, by definition, not a prepayment. There is an exception, however, when a clause clearly and unambiguously provides for a prepayment. Here, the district court found that the make-whole provision did not *clearly and unambiguously* call for the payment of a make-whole premium, notwithstanding both the reference to a date certain—October 15, 2015—as well as the language in

[2] An anti-layering provision, often found in an indenture, prevents, in certain circumstances, the incurrence of debt that is senior to certain existing subordinated debt, but junior to existing senior debt.

[3] Section 1129(b) of the Bankruptcy Code provides that in order to be confirmed, a plan (1) must not unfairly discriminate and (2) must be fair and equitable. Momentive sought to cram down the Senior Lien Notes under section 1129(b)(2)(a)(i), which requires that a dissenting class of secured creditors (I) retain its security interest to the extent of the allowed amount of its secured claim, and (II) receive deferred cash payments with a present value of at least the value of its interest in the collateral securing its claim.

[4] The "formula approach" involves augmenting a risk-free or low risk base rate "to account for the risk of nonpayment posed by borrowers in the []financial position" of the debtor. *Till v. SCS Credit Corp.*, 541 U.S. 465, 471 (2004).

[5] The "efficient market approach" calculates the cramdown interest rate based on the interest rate the market would pay on a new loan having the terms being offered to the dissenting secured creditor under the plan.

[6] *Till*, 541 US 465.

[7] *Till*, 541 US at 477.

[8] The district court was not persuaded by the argument that courts in the Sixth Circuit apply the efficient market rate in the Chapter 11 context; instead, the district court looked to Second Circuit precedent, which was controlling.

the acceleration provision that provided for the payment of, among other things, "premium, if any." The district court distinguished *Chemtura*,[9] where the indenture required a make-whole payment if the debt was repaid prior to its *original* maturity date, which met the clear and unambiguous requirement. Additionally, the district court noted that the holders of Senior Lien Notes bargained for exactly this result by electing to have an automatic acceleration upon a bankruptcy event of default. Finally, the district court found that holders of Senior Lien Notes were not entitled to damages in the amount of the make-whole premium under the common law perfect tender rule or as damages for breach of a provision of the indenture that would have allowed the noteholders to rescind the automatic bankruptcy acceleration. The district court noted that the existence of the make-whole provision modified the perfect tender rule such that the common law remedy was unavailable. Moreover, because it was the automatic stay—and not the debtors—that prevented the noteholders from exercising their right to rescind acceleration, the debtors could not be liable to holders of the Senior Lien Notes for breach of contract.

Conclusion

The farthest-reaching implications of the district court's decision are the portions relating to cramdown interest and make-whole payments. By upholding the bankruptcy court's decision to utilize the *Till* formula approach, the district court has further opened the door to the cram-up of secured creditors through a mechanism that would provide take-back paper at below-market interest rates. It remains to be seen how widely this view will be adopted outside of the Southern District of New York, or whether it will survive further appeal.[10]

The make-whole portion of the ruling adds further weight to the argument against the payment of a make-whole premium in the context of an automatic acceleration provision (absent clear and unambiguous language in the relevant debt document providing that a make-whole is payable post-acceleration or upon automatic acceleration). Notably, unlike the pending issues in the EFIH case in Delaware, this decision did not address the extent to which solvency might impact the ability of holders to lift the stay to revoke an automatic acceleration.

9 *In re Chemtura Corp.*, 439 B.R. 561 (Bankr. S.D.N.Y. 2010).

10 On May 22, 2015, the trustee for the Senior Lien Notes filed a notice of appeal to the United States Court of Appeals for the Second Circuit.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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