Simpson Thacher

Memorandum

Second Circuit in *Momentive* Case Sets Two-Prong Efficient Market Test for Cramdown Noteholders; Splits with Third Circuit in Denial of Make-Whole Premium

November 15, 2017

On October 20, the U.S. Second Circuit Court of Appeals (the "Court") issued a unanimous decision on the highly anticipated Momentive Performance Materials appeal. The case was an appeal of the U.S. district court's affirmation of the bankruptcy court's order confirming the Momentive Chapter 11 plan. The Court's decision largely upheld the plan confirmation as it stood, finding no merit in arguments by senior noteholders that they are entitled to a make-whole premium and confirming that the subordinated notes are junior in priority to the second lien notes. However, the Court found that the challenges were not equitably moot despite substantial consummation of the plan, and, critically, the court held that the wrong standard had been applied by lower courts when evaluating the cramdown rate of interest on the replacement notes issued under the plan. The Court remanded the issue to the bankruptcy court to apply a revised two-step efficient markets approach to establish an appropriate cramdown interest rate.

Background

Momentive proposed a Chapter 11 plan of reorganization that purported to provide for a full recovery for senior lien notes, partial recovery in the form of equity for second lien notes and no recovery for subordinated notes. For senior lien noteholders, the plan provided that if the class voted in favor of the plan, the class would receive a cash payment equal to the outstanding principal and interest on the senior notes, without a make-whole premium, and if the class rejected the plan, the class would receive new replacement notes, while preserving the class's ability to litigate whether a make-whole premium was also due. The class rejected the plan, as did the class of subordinated noteholders. The second lien noteholders unanimously accepted the plan. The plan was confirmed by the bankruptcy court on a "cramdown basis" over the objections of the rejecting classes and the district court affirmed. Both the senior lien noteholders and subordinated noteholders appealed to the Second Circuit. The senior lien noteholders asserted that the

interest rate on the replacement notes was insufficient and they were entitled to a make-whole premium in respect of their notes. The subordinated noteholders asserted that their notes were not subordinated to second lien notes.

Remand for Two-Step Cramdown Interest Rate Approach

In determining the appropriate interest rate on the new replacement notes, Judge Robert Drain of the Bankruptcy Court for the Southern District of New York applied the formula established in the Supreme Court's *Till* holding.[1] That formula, applying a risk-free rate slightly adjusted for certain risk factors, resulted in an interest rate ranging between 4.1% to 4.85%. In the appeal, the senior lien noteholders argued that for the Chapter 11 plan to be "fair and equitable," as required by Section 1129(b) of the Bankruptcy Code, the bankruptcy court should have applied a market based interest rate. In support of their position, the noteholders argued that the higher market rate could easily be established because Momentive had obtained exit financing commitments pricing between 5% to 6%, if not higher. The lower courts disagreed with that position – even though all parties conceded that the cramdown interest rate was below "market" – and instead held that based upon the guidance of *Till* a cramdown interest rate should "not take market factors into account."

The Court of Appeals disagreed and instead outlined the following revised standard, one previously adopted by the Sixth Circuit. First, a court should determine whether an efficient market exists, and if so, it should apply the rate prescribed by that market. If the court is unable to conclude an efficient market exists, it should apply *Till*. The Court reasoned, "where, as here, an efficient market may exist that generates an interest rate that is apparently acceptable to sophisticated parties dealing at arms-length, we conclude, consistent with footnote 14 [*in the Till decision*], that such a rate is preferable to a formula improvised by a court." In *Till*, which was a Chapter 13 case, the Supreme Court recognized (in the often cited footnote 14) that "in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession… it might make sense to ask what rate an efficient market would produce."

We note that the Second Circuit did not decide whether an efficient market existed, or what an appropriate market-based rate of interest would be, instead it remanded those inquiries to the bankruptcy court. Notably, however, the Second Circuit stated that the evidence provided by senior noteholders, including expert testimony regarding the interest rates indicated by the exit financing proposals, would have, if credited, established the existence of an efficient market.

[1] *In re: MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), applying *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004).

Rejection of Make-Whole Premium

The senior lien noteholders argued that Momentive's issuance of the replacement notes constituted a redemption of the prepetition senior lien notes prior to maturity, and therefore, they were entitled to payment of a make-whole premium in accordance with the optional redemption provision in the prepetition indenture. To support that position, the noteholders cited the Third Circuit's recent decision in *Energy Future Holdings*[2], which expressly disagreed with the Momentive lower court decisions denying the make-whole premium. The Third Circuit held that make whole premiums are intended to be a "contractual substitute for interest lost on Notes redeemed before their expected due date." The Second Circuit was unpersuaded for the same reasons it rejected similar arguments in its prior *AMR Corp*. decision.[3]

In *AMR Corp*., the bankruptcy filing accelerated the maturity of the debtor's prepetition debt and thus made it due and payable on the petition date. *AMR Corp*. held that the debtor's repayment was not found to be a 'voluntary prepayment' because, "[p]repayment can only occur *prior* to the maturity date." The Court emphasized that the same logic extends to Momentive, where the senior lien notes were accelerated by the bankruptcy filing, which changed the maturity date to the petition date. The Court reasoned that any payment following the filing must have been a post-maturity payment because the plain meaning of the word 'redeem' means to repay an obligation at or *before* maturity. The Court further reasoned that even if there was a redemption, it did not trigger the optional redemption clause because the issuance of the replacement notes was obligatory due to the automatic acceleration clause in the indenture. The Court found that such a mandatory payment was not at the company's option.

The Court also rejected the senior lien noteholders' claim that they should have been entitled to rescind the acceleration (thereby reinstating the original maturity date and keeping the optional redemption clause in effect). In line with the prior *AMR Corp*. ruling – the indenture in that case had virtually identical language – the Court concluded that a post-petition invocation of a rescission right would violate the automatic stay and be barred as an inappropriate attempt to modify contract rights.

Denial of Subordination Challenge

The class of subordinated noteholders, which did not receive any distribution under the plan, argued that their claims were not subordinate to the second lien noteholders' claims based on the terms of the subordinated notes indenture. The Court upheld the lower court rulings, although it did so on slightly different grounds, finding that the language in the subordinated notes indenture was ambiguous; however, that ambiguity was resolved in favor of the second lien noteholders.

---

[2] *In re: Energy Future Holdings Corp*., 842 F.3d 247 (3d. Cir. 2016).

[3] *In re: AMR Corp*., 730 F.3d 88 (2d Cir. 2013).

The Court found that the relevant analysis turned on whether the second lien notes constituted "senior indebtedness" as defined in the subordinated notes indenture. If the second lien notes did not constitute "senior indebtedness," then the claims of the subordinated notes should not have been subordinated to those of the second lien notes. Specifically, the subordinated notes indenture excluded from the definition of "senior indebtedness" any debt "that by its terms is subordinate or junior *in any respect* to any other" indebtedness (emphasis added). The subordinate noteholders claimed that because the second lien notes' lien was junior to the senior notes' lien, the second lien notes did not constitute "senior indebtedness." The lower courts disagreed with that position finding that a necessary component of the "senior indebtedness" carve out was payment subordination as opposed to lien subordination.

The Court did not agree with that approach, and instead found the "senior indebtedness" definition to be ambiguous – open to differing reasonable interpretations. The Court therefore reviewed extrinsic evidence to resolve this ambiguity. In so doing, the Court found that the evidence, including the representations in the company's SEC filings that the second lien notes were "senior indebtedness," supported the proposition that the second lien notes were intended to constitute "senior indebtedness."

Denial of Equitable Mootness

The Court rejected the debtors' argument that the appeal was equitably moot despite substantial consummation of the plan. The Court reached that conclusion for two salient reasons: the noteholders had diligently sought to challenge the plan and even if they were successful, the financial impact to the debtors could be appropriately managed.[4]

This decision has potentially far-reaching consequences for future restructurings. The holding not only contributes to the standards in determining equitable mootness and subordination, but notably creates a circuit split with the Third Circuit adding uncertainty to the entitlement to make-whole premiums and the application of optional redemption language in the context of bankruptcies. Further, the application by the Second Circuit of the two-step approach to setting cramdown interest rates, already supported by the Sixth Circuit, reinforces the notion that in many chapter 11 cases involving syndicated or public debt, the market rate of interest should prevail rather than the court-imposed formula under *Till* – a positive development for senior creditors.

[4] The debtors acknowledged that a successful challenge would result in an additional $32 million in annual payments over a seven year period, at most, if a 5-6% "market rate" of interest were to be applied to the replacement notes.

For further information about this decision, please contact one of the following members of the Firm's Restructuring and Bankruptcy Department.

NEW YORK CITY

Elisha D. Graff
+1-212-455-2312
egraff@stblaw.com

Sandeep Qusba
+1-212-455-3760
squsba@stblaw.com

Michael H. Torkin
+1-212-455-3752
michael.torkin@stblaw.com

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000