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RESTRUCTURING AND FINANCE DEVELOPMENTS

Rights of Secured Creditors in Chapter 11 – The *Momentive* Decision

Since 2014, when a New York bankruptcy court overruled objections by secured creditors to the chapter 11 plan filed by Momentive Performance Materials, there has been notable uncertainty regarding several issues of importance to secured creditors, including: (a) the ability of debtors to "cram down" secured debt with replacement notes bearing below-market interest rates; (b) the ability of debtors to refinance secured debt in bankruptcy without paying a "make-whole"; and (c) the availability of appellate review of a consummated chapter 11 plan. On October 20, 2017, the Second Circuit issued its much-anticipated decision addressing those issues. Although the court affirmed various rulings in favor of the debtors, including the bankruptcy court's denial of a make-whole, the decision provides secured lenders with increased comfort that they will receive market-based interest on their debt where an "efficient market" exists, and that appellate review of confirmed chapter 11 plans will often be available.

In *Momentive*, the debtors proposed a chapter 11 plan offering a choice to senior secured lenders: They could support the debtors' plan and receive cash payment in full, without any make-whole; or, if they rejected the plan, they would receive seven-year secured notes having a principal amount equal to their allowed secured claim and bearing interest at a Treasury-based rate with a small risk premium. The secured lenders objected, contending that the below-market interest rate failed to provide them with deferred cash payments with a value equal to the amount of their claims, as required by the Bankruptcy Code. The secured lenders also asserted that they were entitled to a "make-whole" as part of their recovery in light of the debtors' decision to satisfy the secured claims with replacement notes prior to their original maturity.

The bankruptcy court ruled in the debtors' favor, holding — based on the Supreme Court's decision in *Till* v. *SCS Credit Corp.*, which involved an individual debtor — that a secured creditor's cramdown paper need only provide interest at the prime rate along with a limited risk spread, as opposed to a market-based rate. Rejecting the argument that this "formula" approach should not apply in cases involving a corporate issuer, the bankruptcy court ultimately required secured creditors to accept interest at a Treasury note rate plus 2% or 2.75% — a rate lower than the asserted market rate. The bankruptcy court also concluded that, in light of the automatic acceleration of the secured debt as a result of the chapter

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11 filing, and the absence of contractual language "clearly and specifically" providing for a make-whole following acceleration, no make-whole was owed to the lenders.

On appeal, the Second Circuit affirmed in most respects, but reversed and remanded on the method of calculating the interest rate on the secured lenders' replacement notes. Based in part on a footnote in the *Till* case — in which the Supreme Court indicated that "it might make sense," in the chapter 11 context, "to ask what rate an efficient market would produce" — the court held that, in determining the interest rate for replacement notes, the bankruptcy court should follow a two-step approach: "[T]he market rate should be applied in Chapter 11 cases where there exists an efficient market. But where no efficient market exists for a Chapter 11 debtor, then the bankruptcy court should employ the formula approach." Since the bankruptcy court did not apply this two-step approach, the Second Circuit remanded with instructions to ascertain if a market rate of interest existed for the new debt distributed to the secured lenders. It remains to be seen how the bankruptcy court will apply that mandate.

In contrast, the Second Circuit affirmed the bankruptcy court's denial of the make-whole amount sought by secured lenders. Momentive's secured creditors contended that satisfaction of the debtors' pre-petition obligations, which had been automatically accelerated due to the bankruptcy, constituted an "optional redemption" under the indentures and thus required payment of a make-whole. Agreeing with the bankruptcy court, the Second Circuit held that the acceleration of the secured loans as a result of the chapter 11 filing meant that the loans were not being redeemed at the Debtors' option, but instead were being repaid *post*-maturity. Thus, under governing New York law, the make-whole was not payable. Notably, in reaching this conclusion, the Court departed from the Third Circuit's 2016 decision in *Energy Future Holdings*, which, as described in a prior memo, held that the debtors' decision to refinance secured debt in bankruptcy *was* a voluntary "redemption" subject to a make-whole under New York law. At this stage, therefore, two courts of appeals have reached divergent results.

Finally, the Second Circuit rejected the contention that the secured lenders' appeal of the interest-rate and make-whole issues should be dismissed as "equitably moot." Under the doctrine of equitable mootness, where a plan of reorganization has been substantially consummated, appellate courts can decline to hear an appeal in order to avoid harm to third parties who participated in the reorganization. In rejecting equitable mootness, the Second Circuit emphasized that, where creditors diligently object to a plan and have a meritorious appeal, an appellate court should grant relief if "at all feasible." In the *Momentive* situation,

the court further concluded that the additional interest payments that could be owed due to the Second Circuit's remand would not unravel the chapter 11 plan.

Although the Second Circuit issued a split decision in *Momentive*, and the interest-rate issue will be addressed on remand by the bankruptcy court, we expect the decision to be welcomed by secured lenders insofar as it reduces the risk of receiving notes under a chapter 11 plan with a below-market interest rate. Unlike the ruling on the make-whole issue — which can be addressed in other cases through clear contractual language requiring a make-whole to be paid — the risk of cramdown at a below-market rate cannot be so readily addressed by contract; the court's ruling thus provides increased clarity to secured lenders with exposure to distressed companies, at least in the Second Circuit.

Richard G. Mason
Joshua A. Feltman
Emil A. Kleinhaus
Angela K. Herring