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Momentive: Key Second Circuit Decision Tackles Make-Whole Premiums and Cramdown Interest

Action Item: Lenders and bankruptcy practitioners will need to consider with care how the Second Circuit's recent *Momentive* decision will impact negotiations of (i) contractual provisions relating to payment of make-whole premiums and (ii) interest rates payable under debt instruments issued pursuant to the terms of chapter 11 cramdown plans.

In a highly anticipated and important opinion for lenders and bankruptcy practitioners alike, the Second Circuit on October 20 decided three separate appeals of the Bankruptcy Court's confirmation order entered in the chapter 11 cases of Momentive Performance Materials, Inc. and various debtor affiliates (collectively, the "Debtor").[1]

As discussed more fully below, the Second Circuit held as follows regarding the four issues raised on appeal: (1) the senior lien noteholders are not entitled to receive a make-whole premium; (2) with respect to the interest rate applicable to certain replacement notes received by senior lien noteholders under the terms of the Debtor's confirmed chapter 11 plan (the "Plan")[2], the Second Circuit reversed and remanded to the Bankruptcy Court for a determination of whether an efficient market rate of interest (as opposed to the "formula" rate of interest applied by the Bankruptcy Court) can be ascertained and, if so, to apply the efficient market rate of interest to the replacement notes; (3) based on consideration of extrinsic evidence of the parties' intent, the second lien notes stand in priority to the subordinated notes; and (4) the appeals were not equitably moot.

1. **The senior lien noteholders are not entitled to receive a make-whole premium as part of their allowed claims under the Plan.**

   Because the senior secured first-lien and 1.5-lien noteholders rejected the Plan, they received replacement notes under the Plan. Those replacement notes failed to account for the make-whole premium provided for under the terms of the relevant 2012 Indentures. The senior lien noteholders argued before the Bankruptcy Court that this failure violated the Indentures.

   The Bankruptcy Court disagreed, reasoning the make-whole premium would be due only in the case of an "optional redemption" and not in the case of an acceleration resulting from a bankruptcy filing.[3] The District Court affirmed.[4]

   The Second Circuit also affirmed after considering and rejecting multiple arguments raised by the respective senior lien noteholders. In doing so, the Second Circuit appears to split from the Third Circuit and its recent ruling dealing with similar make-whole premium issues in the Delaware-based case of *In re Energy Futures Holdings Corp.*[5]

   First, senior lien noteholders argued they were entitled to receive the make-whole premium under the Optional Redemption Clauses contained in the Indentures because issuance of the replacement notes under the Plan constituted a redemption of the notes at the Debtor's option **"prior to maturity."**[6] (Emphasis added.)

Relying on its opinion in *In re AMR Corp.*,[7] the Second Circuit disagreed, finding instead that acceleration resulting from a bankruptcy filing "changes the date of maturity of the accelerated notes to the date of the petition."[8] The Second Circuit further noted the senior lien noteholders' apparent concession that "redeem" means to "repay…a debt security… at or **before maturity.**"[9] (Emphasis added.)

Thus, any payment or redemption made on the accelerated senior notes after the filing of bankruptcy would constitute a **post-maturity** redemption. Because redemption was "post-maturity, not 'at or before' maturity," and because any "redemption" would not have been at the Debtor's option but, rather, arose due to automatic acceleration under the terms of the Indentures, the senior lien noteholders were not entitled to receive payment of the make-whole premium under the terms of the Optional Redemption Clauses.[10]

The senior lien noteholders fared no better arguing entitlement to the make-whole premium under the Automatic Acceleration Clauses. The bankruptcy filing by the Debtor constituted an event of default under Section 6.01(g) of the Indentures. This resulted in automatic acceleration of the senior lien notes under Section 6.02.[11] The senior lien noteholders argued the "premium, if any" language in Section 6.02 required payment of the make-whole premium upon the automatic acceleration caused by the bankruptcy filing.

The Second Circuit disagreed, finding instead that because the more specific Optional Redemption Clauses granting the make-whole premium were not triggered, no make-whole premium was generated and, therefore, could not be due under the Automatic Acceleration Clauses.[12]

Finally, the senior lien noteholders argued on appeal that the lower courts should have permitted them to exercise their contractual rights to rescind the automatic acceleration of the Notes caused by the bankruptcy filing, thereby reinstating the original maturity date and keeping the Optional Redemption Clauses in play.

Relying upon *AMR,* the Second Circuit once again concluded that a creditor's contractual right to rescind an automatic acceleration triggered by a bankruptcy filing "is barred because it would be 'an attempt to modify [a debtor's] contract rights and would therefore be subject to the automatic stay.'"[13] In other words, the senior lien noteholders would not be permitted to rescind the automatic acceleration and effectuate an "end-run" around the bargain struck under the other terms of the Indentures.[14]

2. The lower courts erred in refusing to ascertain and apply an efficient market rate of interest to the replacement notes distributed to senior lien noteholders under the "cramdown" provisions of the Plan.

In addition to objecting to the Plan for its failure to provide them with a recovery on their claims for the make-whole premium, senior lien noteholders also challenged the Plan with respect to the proposed interest rates on the replacement notes distributed to rejecting senior lien noteholders under the terms of the Plan. Those proposed interest rates were 3.6% and 4.09%, respectively.

Senior lien noteholders presented expert evidence at the confirmation hearing in support of their arguments that a market rate of interest should be applied. According to the senior lien noteholders, the open market rate available to the Debtor from an arms-length and willing lender would have fallen in the "5-6+% range."[15]

The Bankruptcy Court disagreed. The Plan was confirmed utilizing the "cramdown" provisions of section 1129(b) of the Bankruptcy Code.[16] The Bankruptcy Court found the Plan to be fair to senior lien noteholders because (i) the relevant Indentures did not require payment of the make-whole premium in the bankruptcy context and (ii) the ultimately allowed interest rates on the proposed replacement notes, although lower than open market rates, were determined by a formula that complied with the requirements of the Bankruptcy Code.[17]

The 2004 Supreme Court case *Till v. SCS Credit Corp.* factored prominently into the Bankruptcy Court's decision on the appropriate interest rates.[18] Rejecting an open market approach, the Bankruptcy Court found that the interest rates should be tied to a "formula" rate, ultimately selecting interest rates of 4.1% and 4.85%, respectively. These rates were "largely risk-free rates slightly adjusted for appropriate risk factors."[19]

On appeal, the Second Circuit determined that the formula approach utilized in *Till,* a chapter 13 cramdown case, did not control establishment of the appropriate rate of interest under the terms of a chapter 11 cramdown plan.[20] Instead, the Second Circuit held that bankruptcy courts should determine whether an efficient market rate of interest exists and if so, apply that rate. If no efficient market rate exists, the *Till* formula approach should be utilized.[21]

The Second Circuit reversed the lower courts' rulings on the appropriate interest rates and remanded the case so the Bankruptcy Court "can ascertain if an efficient market rate exists and, if so, apply that rate, instead of the formula rate."[22]

3. **The second lien notes stand in priority to the subordinated notes based on the parties' intent that the second lien notes qualify as "Senior Indebtedness" under the relevant Indenture.**

The subordinated noteholders received no recovery under the Plan. They challenged the Plan by arguing their Notes were not subordinate to second lien notes and therefore were entitled to receive some recovery under the Plan.

The lower courts found the relevant Indenture to be unambiguous. They rejected the subordinated noteholders' argument that the second lien notes were carved out of the basic definition of "Senior Indebtedness" under the Indenture.[23] The lower courts reasoned the second lien notes unambiguously constituted "Senior Indebtedness" under the Indenture based upon a conclusion that payment subordination—and not lien subordination—was carved out from the "Baseline Definition."[24]

On appeal, the Second Circuit found the relevant Indenture provisions to be ambiguous on the issue of whether the definition of "Senior Indebtedness" included the second lien notes.[25] Moreover, the Second Circuit noted that such an interpretation rendered other language in the Indenture superfluous.[26] The Second Circuit resolved the ambiguity in favor of the second lien notes' priority following consideration of certain extrinsic evidence that, according to the Second Circuit, demonstrated the intent of the parties to treat the second lien notes as "Senior Indebtedness."[27]

4. **The Second Circuit declined to dismiss the appeals as equitably moot.**

The Second Circuit declined to dismiss the *Momentive* appeals as equitably moot.[28] In doing so, the Second Circuit reaffirmed the legal presumption that an appeal of a substantially consummated reorganization plan is equitably moot. This presumption, however, may need to "give way" after consideration of certain factors designed to balance the importance of finality in bankruptcy proceedings against an appellant's right to review and relief.[29]

In applying those balancing factors, the Second Circuit first noted appellants' prompt and consistent efforts to obtain a stay at three different levels of the proceedings. The Second Circuit also concluded that the results expected to flow from the "limited nature of the remand" would not "unravel the plan, threaten Debtors' emergence, or otherwise materially implicate the concerns identified in *Chateaugay II.*"[30]

Conclusion

It remains unclear whether any of the parties to the *Momentive* appeals will file a motion for reconsideration, seek a rehearing en banc, or seek review by the U.S. Supreme Court. Assuming *Momentive* stands, lenders and bankruptcy practitioners will need to consider with care how the decision should impact the drafting of contractual provisions relating to payment of make-whole premiums, as well as negotiations over the interest rates required on debt instruments critical to the successful confirmation and implementation of future chapter 11 cram-down plans. Moreover, it will be interesting to track how, if at all, the apparent split between the Second and Third Circuits on the enforceability of make-whole claims in bankruptcy cases will impact choice of venue in future chapter 11 bankruptcy cases.

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1. *Apollo Global Mgmt., LLC v. Bokf, NA* (*In re MPM Silicones, L.L.C.*), Nos. 15-1682; 15-1824, 15-1771, 2017 WL 4772248 (2d Cir. Oct. 20, 2017) (hereafter, *"Momentive"*).
2. The Plan was confirmed by order entered on October 24, 2014. *See In re MPM Silicones, LLC,* Case No. 14-22503 (RDD) (Bankr. S.D.N.Y.)[Docket No. 1001].
3. *In re MPM Silicones, LLC,* 2014 WL 4436335, at **15-16 (Bankr. S.D.N.Y. 2014) (hereafter, *"Momentive Bankruptcy Decision"*). The bankruptcy cases were filed in April 2014.
4. *In re MPM Silicones, LLC,* 531 B.R. 321 (S.D.N.Y. 2015).
5. *Del. Trust Co. v. Energy Future Intermediate Holding Co. LLC* (*In re Energy Future Holdings Corp.*), 842 F.3d 247, 255 (3d Cir. 2016). In this decision, the Third Circuit addressed similar make-whole premium language contained in two indentures. Relying upon the language of the indentures, the Third Circuit reversed the Delaware Bankruptcy Court's ruling that no make-whole premium payments were due. The Third Circuit, applying New York law, remained unpersuaded a "redemption" did not include both pre- and post-maturity repayments of debt. It found that the EFIH Debtor's post-bankruptcy refinancing of the notes qualified as a "redemption" under the express terms of the indentures, thereby triggering the make-whole obligations.
6. *Momentive* at *11.
7. *In re AMR Corp.,* 730 F.3d 88 (2d Cir. 2013).
8. *Momentive* at *11 (citing AMR Corp., 730 F.3d at 103).
9. *Id.*
10. *Id.*
11. Section 6.02 of the Indentures provided: "If an Event of Default specified in Section 6.01(f) or (g) with respect to MPM occurs, the principal of, **premium, if any**, and interest on all the Notes shall i*pso facto* become and be immediately due and payable without any declaration or other act on the part of the Trustee or any Holders." *Momentive* at *11 n. 15 (emphasis added).
12. *Momentive* at *12.
13. *Id.* (quoting *AMR Corp.,* 730 F.3d at 102).
14. *Id.*
15. *Momentive* at *7.
16. Section 1129(b)(1) permits confirmation of a chapter 11 plan, notwithstanding non-accepting classes, if the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." *Momentive* at *3 (quoting 11 U.S.C. § 1129(b)(1)).
17. *Momentive Bankruptcy Decision* at *29.
18. *Till v. SCS Credit Corp.,* 541 U.S. 465 (2004).
19. *Momentive* at *7. The Bankruptcy Court began with the Treasury rate as the baseline interest rate, subject to upward adjustment after consideration of certain risk factors. *See Id.* n. 7.
20. *Momentive* at * 8, discussing *Till* at 476 n.14 (Till court specifically noting the likely availability of an efficient and willing lending market in a chapter 11 plan scenario as opposed to "no free market of willing cramdown lenders" available in a chapter 13 cramdown scenario).
21. *Momentive* at **8-9, adopting the approach set forth in *In re American HomePatient, Inc.,* 420 F.3d 559, 568 (6th Cir. 2005).
22. *Momentive* at *10. The Second Circuit, in its address of the equitable mootness arguments raised by the Debtor, noted that based on acknowledgments by the Debtor, any additional interest awarded to senior lien noteholders on remand was not expected to exceed $32 million over seven years. *Id.* at *13.
23. *Momentive* at *4. The meaning of "Senior Indebtedness" under the Indenture begins with the "Baseline Definition," which defines Senior Indebtedness as "all Indebtedness…unless the instrument creating or evidencing the same or pursuant to which the same is outstanding expressly provides that such obligations are subordinated **in right of payment** to any other Indebtedness of the Company…." *Id.* (emphasis added.) However, the Baseline Definition is subject to six enumerated exceptions, the fourth of which excepts from Senior Indebtedness "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…." *Id.* at *4 (emphasis added).
24. *Momentive* at *4. The lower courts reasoned that because the second lien notes were not subordinate in payment to other note classes—but rather, only the liens supporting the notes were subordinate—the second lien notes were not covered by the fourth exception. *Id.*
25. *Momentive* at *5. On the one hand, the Second Circuit reasoned that the fourth exception does not expressly state "subordinate…**in right of payment**". *Id.* The Second Circuit further noted the parties by the fourth exception could have made express (but did not) the type of subordination to which they were referring. *Id.* On the other hand, the Second Circuit reasoned that if the fourth exception excluded second lien notes from the definition of "Senior Indebtedness," the Baseline Definition's more limited carve-out for debt subordinate "**in right of payment**" would be unnecessary, because all debt would be carved out by the broader language found in the fourth exception which used "in any respect". *Id.* Ultimately, the Second Circuit found the relevant Indenture provisions to be ambiguous, thereby necessitating consideration of extrinsic evidence.
26. *Momentive* at *5. Specifically, if the fourth exception excepted only debt subordinate in right of payment, there was no purpose served by the "in right of payment" carve-out contained in the Baseline Definition. *Id.*
27. *Momentive* at *6. Among other things, the Debtor repeatedly represented to the Securities and Exchange Commission and financial community that the second lien notes were "Senior Indebtedness"; also, interpretation of "in any respect" to cover **all** junior liens nonsensically would require a conclusion that **none** of the senior note classes would qualify as Senior Indebtedness because each was secured in some respect by a junior lien (note classes were subordinate to pre-existing liens on the Debtors' assets). *Id.*
28. *Momentive* at *13.
29. *See In re BGI, Inc.*, 772 F.3d 102, 104 (2d Cir. 2014); *In re Charter Commc'ns Inc.,* 691 F.3d 476, 481 (2d Cir. 2012).
30. *Momentive* at *13. *See In re Chateaugay,* 988 F.2d 322 (2d Cir. 1993) (*"Chateaugay II"*) (the five factors are: (i) effective relief can be ordered; (ii) relief will not affect the debtor's re-emergence; (iii) relief "will not unravel intricate transactions"; (iv) affected third-parties are notified and able to participate in the appeal; and (v) appellant diligently sought a stay of the reorganization plan).