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A Potentially Momentous Decision: Second Circuit Explains How to Calculate Chapter 11 Cramdown Interest Rate

By Stuart I. Gordon and Matthew V. Spero*

The U.S. Court of Appeals for the Second Circuit has issued a long-awaited decision that may make it more difficult for Chapter 11 debtors to cram down secured creditors.

More than a decade ago, in the Chapter 13 case of *Till v. SCS Credit Corp.*,[1] a plurality of the U.S. Supreme Court endorsed the "formula" method for bankruptcy courts to use when calculating the interest on deferred payments payable under a confirmed Chapter 13 plan to a secured creditor to enable the creditor to receive the full value of its claim as required by Bankruptcy Code Section 1325(a)(5)(B)(ii).[2]

The formula approach endorsed by the *Till* plurality instructed a bankruptcy court to begin with a largely risk-free interest rate, specifically, the "national prime rate . . . which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default." Under *Till*, the bankruptcy court then should hold a hearing to determine a proper plan-specific risk adjustment to that interest rate at which the debtor and any creditors may present evidence. Using this approach, bankruptcy courts in Chapter 13 cases generally have approved adjustments above the base interest rate of one percent to three percent.

Although *Till* was a Chapter 13 case, various bankruptcy courts since *Till* have relied on the formula method when determining the proper interest rate

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1 *Till v. SCS Credit Corp.*, 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004).

2 Section 1325(a)(5)(B)(ii) allows Chapter 13 debtors to provide secured creditors with future property distributions (such as deferred cash payments) whose total "value, as of the effective date of the plan, . . . is not less than the allowed amount of such claim." 11 U.S.C. § 1325(a)(5)(B)(ii).

under the cramdown provision of Chapter 11, Bankruptcy Code Section 1129(b)(2)(A)(i)(II), which requires the payment of interest on deferred payments payable to a secured creditor in an amount that will afford the creditor the full present value of its secured claim.[3]

Now, however, the U.S. Court of Appeals for the Second Circuit, in *Momentive Performance Materials Inc. v. BOKF, NA (Matter of MPM Silicones, L.L.C.)*,[4] has ruled that the Chapter 11 cramdown interest rate should be an appropriate market rate, if available, and not the formula rate.

As a practical matter, the circuit court's decision appears to provide more leverage to secured creditors when negotiating the terms of a plan of reorganization or opposing confirmation of a proposed plan of reorganization. Correspondingly, it also may very well make it more difficult for Chapter 11 debtors to cram down secured creditors in Chapter 11 cases, which may result in the confirmation of fewer contested Chapter 11 plans and the dismissal of unconfirmable Chapter 11 cases or their conversion to Chapter 7.

At least one thing is clear, however. The *Momentive* ruling has set the standard to be used by bankruptcy courts in the Second Circuit to determine the appropriate interest rate payable to secured creditors in Chapter 11 when plans are confirmed over their objection. It is up to New York, Connecticut, and Vermont bankruptcy courts to implement the circuit court's decision.

BACKGROUND

Momentive Performance Materials, Inc. ("MPM"), a silicone producer, took on significant new debt obligations beginning in the mid-2000s. In 2006, MPM issued $500 million in subordinated unsecured notes. In 2010, MPM issued approximately $1 billion in "springing" second-lien notes.

MPM issued more debt in 2012, this time in the form of two classes of senior secured notes. Specifically, MPM issued $1.1 billion in first-lien secured notes (the "First-Lien Notes") and $250 million in 1.5-Lien secured notes (the "1.5-Lien Notes" and, with the First-Lien Notes, the "Senior-Lien Notes"). BOKF and Wilmington Trust were the indenture trustees for the First-Lien Notes and 1.5-Lien Notes, respectively.

Pursuant to the governing indentures, the Senior-Lien Notes were to be repaid in full by their maturity date of October 15, 2020. They carried fixed

[3] *See, Rake v. Wade*, 508 U.S. 464, 472 n.8, 113 S. Ct. 2187, 124 L. Ed. 2d 424 (1993).

[4] *Momentive Performance Materials Inc. v. BOKF, NA (Matter of MPM Silicones, L.L.C.)*, 874 F.3d 787 (2d Cir. 2017).

interest rates of 8.875 percent for the First-Lien Notes, and 10 percent for the 1.5-Lien Notes.

After issuing the Senior-Lien Notes and other notes, MPM experienced significant financial problems. In April 2014, MPM and a number of its affiliates filed for Chapter 11 in the Southern District of New York. Ultimately, the debtors submitted a plan of reorganization to the bankruptcy court. Among other things, the plan provided for a 100 percent cash recovery of the principal balance and accrued interest on the Senior-Lien Notes.

The plan also gave the holders of the Senior-Lien Notes the option of:

- Accepting the plan and immediately receiving a cash payment of the outstanding principal and interest due on their notes; or
- Rejecting the plan and receiving replacement notes "with a present value equal to the [a]llowed amount of such holder's [claim]." Toward that end, the plan proposed interest rates on the replacement notes of 3.6 percent and 4.09 percent, respectively.

The holders of the Senior-Lien Notes rejected the plan. They contended that the replacement notes failed to comply with the Bankruptcy Code because the interest rate payable on the replacement notes was well below ascertainable market rates for similar debt obligations and thus was not "fair and equitable," as it failed to give them the present value of their claims.

Following a four-day hearing, the bankruptcy court confirmed the plan. Confirmation was facilitated by Chapter 11's cramdown provision, which allows a bankruptcy court to confirm a reorganization 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."[5]

The bankruptcy court decided that the interest rates proposed in the plan (3.6 percent and 4.09 percent) should be increased by 0.5 percent and 0.75 percent, respectively, in light of the fact that the base interest rate was pegged to the Treasury rate, rather than the prime rate (which reflected additional risk). The bankruptcy court then concluded that the plan was fair to the holders of the Senior-Lien Notes because the interest rate on the proposed replacement notes—4.1 percent and 4.85 percent, respectively—had been determined by a formula that complied with the Bankruptcy Code's cramdown provision.

Notably, the bankruptcy court decided that a cramdown interest rate should "not take market factors into account." Viewing itself as "largely governed by

[5] 11 U.S.C. § 1129(b)(1).

the principles enunciated by the plurality opinion in *Till*," the bankruptcy court concluded that the proper rate was what the plurality in *Till* had referred to as the "formula" or "prime-plus" rate.

The U.S. District Court for the Southern District of New York affirmed the bankruptcy court's confirmation order. The district court essentially agreed with the bankruptcy court, finding, among other things, that the interest rate selected by the bankruptcy court complied with the Bankruptcy Code.

The dispute was appealed to the Second Circuit.

There, the holders of the Senior-Lien Notes contended that the lower courts had erroneously applied a below-market interest rate to their replacement notes. The holders of the Senior-Lien Notes argued that because that rate was too low, the plan was not fair and equitable as required by Bankruptcy Code Section 1129(b). They argued that the lower courts should have applied a market rate of interest—namely, the rate MPM would pay to a contemporaneous sophisticated arms-length lender in the open market. The holders of the Senior-Lien Notes argued in the bankruptcy court that such a market existed and would generate interest in the range of five to six percent or even somewhat more.

For their part, the debtors defended the bankruptcy court's application of the "formula" method on the ground that it was required by the Supreme Court's plurality opinion in *Till*.

THE SECOND CIRCUIT'S DECISION

The circuit court agreed with the holders of the Senior-Lien Notes with respect to the method of determining the interest payable to them.

In its decision, the Second Circuit first reviewed *Till*. The circuit court explained that at issue in *Till* was a Chapter 13 debtor's sub-prime auto loan, carrying an interest rate of 21 percent and providing the creditor with a $4,000 secured claim. The question became how to calculate the interest on deferred payments to the creditor such that the creditor would receive the full value of its claim.

As the Second Circuit observed, no single method of calculating interest secured a majority vote on the Supreme Court, resulting in a plurality opinion endorsing the "formula" method. The *Till* plurality arrived at the "formula" rate after rejecting a number of alternative methods relied on by the lower courts. The plurality rejected methods relying on purported "market" rates of interest, reasoning that those rates "must be high enough to cover factors, like lenders' transactions costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans." The plurality then identified the only factors it viewed as relevant in properly ensuring that the sum of deferred payments equaled present value:

- The time-value of money;
- Inflation; and
- The risk of non-payment.

The Second Circuit pointed out that the Supreme Court's plurality opinion concluded that the "formula" or "prime-plus" method best reflected those considerations. Moreover, the Second Circuit found that although *Till* involved a Chapter 13 petition, the plurality intimated that the formula method might be applicable to rate calculations made pursuant to other similarly worded Bankruptcy Code provisions. Indeed, the Second Circuit noted that the plurality opinion in *Till* cited the Chapter 11 cramdown provision, 11 U.S.C. § 1129(b)(2)(A)(i)(II), among other provisions, when it said that "[w]e think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these [Bankruptcy Code] provisions."

The Second Circuit said, however, that despite that language, the plurality in *Till* made no conclusive statement as to whether the formula rate generally was required in Chapter 11 cases.

In addition, the Second Circuit emphasized that the plurality in *Till* went on to state, in footnote 14 of its opinion, that the approach it felt best applied in the Chapter 13 context might *not* be suited to Chapter 11.[6] Specifically, in that footnote, the Supreme Court stated that in Chapter 13 cramdowns "there is no free market of willing cramdown lenders." It continued: "Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing

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[6] Footnote 14 of the plurality opinion in *Till* states in full:

This fact helps to explain why there is no readily apparent Chapter 13 "cram down market rate of interest": Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. See, *e.g.*, Balmoral Financial Corporation, http://www.balmoral.com/bdip.htm (all Internet materials as visited Mar. 4, 2004, and available in Clerk of Court's case file) (advertising debtor in possession lending); Debtor in Possession Financing: 1st National Assistance Finance Association DIP Division, http://www.loanmallusa.com/dip.htm (offering "to tailor a financing program . . . to your business' needs and . . . to work closely with your bankruptcy counsel"). Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

for Chapter 11 debtors in possession. Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."[7]

As the Second Circuit then observed, the U.S. Court of Appeals for the Sixth Circuit has relied on footnote 14 to conclude that efficient market rates for cramdown loans cannot be ignored in Chapter 11 cases. The Second Circuit pointed out that the Sixth Circuit had adopted a two-part process for selecting an interest rate in Chapter 11 cramdowns:

> [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 endorsed by the *Till* plurality.[8]

The Second Circuit then itself adopted the Sixth Circuit's two-step approach, declaring that it "best" aligned with the Bankruptcy Code "and relevant precedent." The Second Circuit stated that it did not read the *Till* plurality as meaning that efficient market rates were irrelevant in determining value in the Chapter 11 cramdown context. The circuit court added that disregarding available efficient market rates "would be a major departure" from longstanding precedent dictating that "the best way to determine value is exposure to a market."

The Second Circuit noted that the holders of the Senior-Lien Notes had presented expert testimony in the bankruptcy court "that, if credited, would have established a market rate." In the circuit court's opinion, this evidence showed that if the holders of the Senior-Lien Notes were to have approved the plan and accepted a cash-out payment for their notes, MPM would have had to secure exit financing to cover the lump-sum payment. In preparation for that possible eventuality (which did not come to pass in light of the Senior-Lien Notes holders' rejection of the plan), MPM went out into the market seeking lenders to provide that financing—and those lenders quoted MPM rates of interest ranging between five percent and somewhat over six percent.

In the circuit court's opinion, the lower interest rate confirmed by the bankruptcy court required, in essence, that the holders of the Senior-Lien Notes lend the MPM debtors "a significant sum of money and receive a much lower

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[7] Internal citations omitted; emphasis in original.

[8] *In re American HomePatient, Inc.*, 420 F.3d 559, 568 (6th Cir. 2005). A number of courts in the Second Circuit have followed the *American HomePatient* approach. *See, e.g., In re 20 Bayard Views, LLC*, 445 B.R. 83, 108–09 (Bkrtcy. E.D.N.Y. 2011) (collecting cases and following approach outlined in *American HomePatient*).

rate of interest than any other lender would have received for offering the same loan to MPM on the open market."

The Second Circuit acknowledged that, when dealing with a sub-prime loan in the Chapter 13 context, "value" could be elusive because the market was "not necessarily efficient" and the borrower was "typically unsophisticated." The circuit court concluded, however, that "where an efficient market may exist" that generates an interest rate apparently acceptable to sophisticated parties dealing at arms-length, such a rate was "preferable to a formula improvised by a court."

CONCLUSION

The Supreme Court has not spoken about the interest-calculation method to be applied in a Chapter 11 case since *Till*, which makes the Second Circuit's decision in *Momentive* all the more significant.

The Second Circuit's decision, however, has left much to resolve. For one thing, the Second Circuit suggested that an efficient market was one that offered "a loan with a term, size, and collateral comparable to the forced loan contemplated under the cramdown plan." With that said, the circuit court remanded the case so the *Momentive* bankruptcy court could ascertain "if an efficient market rate exists and, if so, apply that rate, instead of the formula rate." The bankruptcy court may determine that an efficient market rate does not exist in this case—a conclusion that may be especially likely given that the bankruptcy court previously had declared, with respect to *American HomePatient*'s two-step approach, that "the first step of the two-step approach is almost, if not always, a dead end" and that the "considerable time" bankruptcy courts spend determining that no efficient market exists leads them to use a formula approach. If the *Momentive* bankruptcy court on remand decides that no efficient market exists, it could very well reach the same conclusion it previously reached when it confirmed the MPM plan.

The Second Circuit also conceded that the "complexity" of the task of determining an appropriate market rate would "vary from case to case," and that the task in some cases would be "straightforward" while in other cases "more complex." Practically speaking, it may not be easy to discern a market rate—or even to know whether there is a market rate—until a Chapter 11 case has proceeded quite far along.

Finally, a question remains over whether bankruptcy courts should use the prime rate rather than the Treasury rate as the base rate when deciding the interest rate in Chapter 11 cramdown cases. In *Momentive*, the holders of the Senior-Lien Notes argued in their appeal to the district court that the bankruptcy court had erred in not requiring the prime rate. The district court rejected that argument and the holders of the Senior-Lien Notes did not press their argument before the Second Circuit, so the circuit court did not opine on that issue. Future litigation may be needed to resolve this particular question.