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MPM Silicones Latest Court to Whittle Away at Secured Creditor Protections: Plan Confirmed Providing Secured Creditors with Below Market Replacement Notes

In an important bench ruling in the MPM Silicones[1] case, Judge Robert Drain of the U.S. Bankruptcy Court for the Southern District of New York has provided debtors with a potentially coercive tool to use as leverage against their secured creditors. By interpreting § 1129(b)(2)(A)(i)(II) (the "Cramdown Provisions") using case law thought previously only to apply to chapter 13 consumer bankruptcy cases, chapter 11 debtors may now be permitted to exchange high-yield secured notes for long-term replacement debt bearing below-market rates.

In the *MPM Silicones* case, Judge Drain confirmed the Debtors' chapter 11 plan of reorganization (the "*Plan*") despite being overwhelmingly rejected by the First Lien Noteholders and the 1.5 Lien Noteholders (collectively, the "*Senior Noteholders*"). Judge Drain found that the Plan, which provided for new replacement notes for the Senior Noteholders that bore below market interest rates, satisfied the Cramdown Provisions of the Bankruptcy Code. Judge Drain held that the Cramdown Provisions were satisfied where a debtor simply offers replacement notes bearing an interest rate composed of the sum of: (i) the U.S. Treasury rate for debt of similar duration, plus (ii) a risk premium reflecting the repayment risk associated with the debtor, which Judge Drain noted would "normally [be] in the range of between one to three percent, if at all,"[2] and need not reflect any amounts for a lender's profits, costs or fees. Based on his judgment, Judge Drain confirmed the Debtors' Plan which provided for replacement notes with a 4.1% coupon on seven-year notes for the First Lien Noteholders, and a 4.85% coupon on seven-and-a-half year notes for the 1.5 Lien Noteholders.

Judge Drain's decision could have serious implications for all secured creditors: forcing them to choose between: (i) accepting a plan with compromised terms, such as the release of all claims to disputed amounts (whether such claims are for a make-whole amounts, default interest or some other type of disputed payment), or (ii) vote against the plan and face the possibility of receiving long-term low-interest rate notes in return for their market rate secured debt. Should this ruling stand upon appeal, the *MPM Silicones* decision will likely have a profound chilling effect on all secured creditors and could significantly raise the cost of secured credit.

Background of the *MPM Silicones* Decision

One of the chief issues in the *MPM Silicones* case was whether the Senior Noteholders were entitled to make-whole payments if the secured notes were paid prior to their stated maturity. As a result, shortly after commencing its bankruptcy case, Debtors filed an adversary proceeding seeking a declaratory judgment from the bankruptcy court that, on account of an automatic acceleration of the notes upon the bankruptcy filing, no make-whole payments were required to be paid to the Senior Noteholders.[3] The Senior Noteholders challenged Debtors' request and sought a declaratory judgment finding that payment of the make-whole amounts was required should the notes be paid in advance of their stated maturity.

In an effort to coerce the Senior Noteholders to give up their pursuit of the make-whole payments, Debtors' Plan contained a so called "deathtrap" provision. If the Senior Noteholders voted to accept the Plan, the Senior Noteholders would receive cash for the full amount of their claim. However, to receive this cash payment, the Senior Noteholders must waive their claim to the make-whole amounts. If, on the other hand, the Senior Noteholders did not accept the Plan, and determined to pursue the make-whole amounts, they would instead receive replacement notes bearing interest at the following rates: (i) with respect to the First Lien Notes, the U.S. Treasury interest rate plus a risk premium of 1.5%, or 3.60%, and (ii) with respect to the 1.5 Lien Notes, the U.S. Treasury interest rate plus a risk premium of 2.0 or 4.09%, far below the original issue interest rates and the current market rate for such debt.[4]

Determined to pursue the make-whole payments, the Senior Noteholders overwhelmingly rejected the Plan, with

more than 90% in value voting to reject. Despite failing to obtain the required number of votes in favor of the Plan from the Senior Noteholders, Debtors determined to cramdown the Plan over the Senior Noteholders' objection pursuant to § 1129 of the Bankruptcy Code.

Court Held Debtors' Plan Meets the Cramdown Requirements of Section 1129

The Cramdown Provisions of the Bankruptcy Code contained in § 1129(b)(2) allow for a plan to be confirmed over the objection of a non-accepting class of creditors provided that the plan is "fair and equitable" to such non-accepting class of creditors. This section further provides that a plan is "fair and equitable" if it allows secured creditors to: (i) "retain their liens securing such claims" and (ii) "receive … deferred cash payments totaling at least" the *present value of their claims*.[5]

Because the replacement notes were to have similar liens as the Secured Notes, the chief inquiry facing the Court was whether the replacement notes would grant holders deferred cash payments of the present value of their claims.[6] Finding no direct chapter 11 precedent, Judge Drain looked to § 1325(a)(5)(B)(ii), which he held was closely analogous, and also the Supreme Court's plurality opinion in *Till v. SCS Credit Corp.*[7] and the Second Circuit's decision in *In re Valenti*,[8] both of which specifically addressed the requirements of the present value test, albeit in a chapter 13 (consumer bankruptcy) context.

Judge Drain found that the objective of both § 1325(a)(5)(B)(ii), and by analogy, § 1129(b)(2)(A), is to put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately.[9] When dealing with payments over time, the purpose is not "to put the creditor in the same position that it would have been in had it arranged a 'new' loan."[10] Rather, the court's duty is to determine the rate for a loan of this specific type — a "cramdown loan," which is one imposed by the court over the objection of the secured creditors. Among other things, Judge Drain held that an important feature of this type of loan, required by both *Till* and *Valenti*, was that, unlike other commercial financing, cramdown loans must not contain any profit or cost element for the creditors.[11]

Since no market exists for cramdown loans, and debtor-in-possession loans and exit financing both differ from cramdown loans on account of their inherent profit component for lenders, Judge Drain concluded, again relying on *Till* and *Valenti*, that the governing rate for a cramdown loan should be a formula composed of:

> … a risk free base rate which would the be increased by a percentage, reflecting a risk factor, based on the circumstances of the estate, the nature of the collateral security and the security itself, and the duration and feasibility of the reorganization plan.[12]

Again, following both *Till* and *Valenti*, the Court held that, "generally speaking, that risk adjustment should be between one percent and three percent."[13]

Despite the Senior Noteholders' argument that the repayment risk component should be higher because, among other things, the Debtors had missed numerous economic projections, Judge Drain found a low risk premium was still called for as the Debtors' debt to equity basis was better than the coverage in *Till*, collateral coverage was lower and their would be a substantial equity cushion.

While Judge Drain generally upheld the Plan, he determined that higher interest rates were required. Specifically, Judge Drain stated that:

> I think there should be an additional risk amount added on in light of the fact that a Treasury rate was used as the base rate where the obligor is the U.S. government. The additional increment, I believe, should be another .5 percent for the … senior replacement loan, and an additional .75 percent for … one-and-a-half lien paper. I believe that that formula or that approach adequately takes into account risk based upon a base Treasury rate.[14]

The Debtors amended their Plan in accordance with the Judge's comments, and Judge Drain confirmed the Debtors' Plan. Judge Drain also denied that a make-whole payment was triggered on the early repayment of the notes.

Given the outcome presented to them — no make-whole payment and a recovery based on low-interest replacement notes — the Senior Noteholders filed a motion seeking authorization from the Bankruptcy Court to change their votes, which they had hoped would permit them to vote in favor of the Plan and receive cash instead of the replacement notes. The Court denied this request. Creditors have also since announced that they will seek to appeal the decision.

Conclusion

By permitting debtors to pay their secured creditors with long term notes having below-market interest rates, and approving a plan structure containing a "deathtrap" provision, Judge Drain's *MPM Silicones* ruling may give chapter 11 debtors a powerful new weapon against secured creditors. Using the treat of payment in a low

yielding currency, debtors may now attempt to hold secured creditors hostage – forcing them to either vote yes and accept comprised terms, or vote against a plan and receive a below market recovery. To the extent this ruling is upheld or followed by other courts, this new interpretation of the Cramdown Provisions has powerful implications for all holders of secured debt and such decisions should be closely followed by all secured creditors.

1. *In re MPM Silicones*, LLC, et al., Case No. 14-22503-RDD (Bankr. S.D.N.Y. Aug. 26, 2014).
2. *Id*. at 77:1-3.
3. *In re MPM Silicones, LLC*, Adversary Proceeding No. 14-08227.
4. Transcript ("*Tr.*") at 63:23-64:7.
5. 11 U.S.C. 1129(b)(2)(A)(i) (emphasis added).
6. "The issue is …whether, in fact, that is the holders will receive on account of such claim deferred cash payments totaling the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." Tr. at 63:10-15.
7. 541 U.S. 465 (2004).
8. 105 F.3d 55 (2d Cir. 1997).
9. Tr. at 67:6-11.
10. *Id*.
11. *Id*. at 67:12-16.
12. *Id*. at 68:5-10.
13. *Id*. at 68:10-12; 77:2-3.
14. *Id*. at 83:20-84:3.

For More Information

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