2014 Creditors' Rights

Implications of a Changing Landscape for Secured Creditors

October 2014

Chapman and Cutler LLP

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2014 CREDITORS' RIGHTS:

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Introduction

Thus far, 2014 has been a challenging year for secured creditors exercising rights in bankruptcy proceedings. Over the past several months a number of important decisions have served to erode the rights of secured lenders and purchasers of distressed loans in the secondary market. These challenges to the rights of secured creditors has been swift and proceeded on a variety of different fronts.

These decisions range from the *Fisker Automotive* and *Free Lance-Star* decisions, which expanded the definition of "cause" under § 363(k) of the Bankruptcy Code to limit secured creditors' right to credit bid their secured claims, to the *MPM Silicones* case, where a chapter 11 plan was confirmed by cramming down a plan that only provided secured creditors with replacement notes bearing below market interest rates. In addition, given the ultra-low interest rate environment, disputes regarding make-whole payments and default interest have come to the forefront of many bankruptcy cases, leaving many creditors unsure of the state of the law and how it will affect them.

Chapman attorneys have been monitoring these decisions and developments and have distributed client alerts that we hope provided important insight regarding the implications of these decisions for holders of secured debt and highlight what every creditor should know in order to effect rights under its credit agreement.

We have compiled in one booklet, for your convenience, all of our secured creditor client alerts distributed to date in 2014. These include the following:

- *New Challenge to Credit Bidding – Distressed Debt Purchasers Beware*
- *Recent Challenges to Credit Bidding – A New Trend?*
- *Make-Whole Provisions Continue to Cause Controversy: What You Can Do to Avoid Litigation*
- *I'm a Secured Creditor so I'm Entitled to Default Interest, Right?*
- *MPM Silicones Latest Court to Whittle Away at Secured Creditor Protections: Plan Confirmed Providing Secured Creditors with Below Market Replacement Notes*

We hope that having these alerts in one convenient place will assist our clients and friends in understanding these decisions, their implications and the changing landscape for secured creditors. We hope that you find them to be helpful and informative.

February 12, 2014

New Challenge to Credit Bidding – Distressed Debt Purchasers Beware

The right of a secured creditor to "credit bid" (i.e., to bid the amount of debt owed rather than cash) in a debtor's sale of assets, once thought to be rock solid, is again under attack. A recent decision in the Fisker Automotive case[1] is very troubling in that it severely limited a secured creditor's right to credit bid by capping the amount of the credit bid at the purchase price paid to acquire the secured claim. The Bankruptcy Court in Fisker Automotive held that "cause" existed under Section 363(k) of the Bankruptcy Code to limit the secured creditor's credit bid because (i) doing so would promote an active auction and (ii) there were concerns regarding the extent and validity of the secured creditor's liens on some of the assets that were to be sold. The secured creditor appealed the Bankruptcy Court's decision, but the District Court declined to hear the appeal and, in its decision, lent support to the Bankruptcy Court's ruling. As it stands, the Fisker Automotive decision presents a serious challenge to secured creditors and purchasers of distressed loans in the secondary market.

Right to Credit Bid

Section 363(k) of the Bankruptcy Code provides that a holder of an allowed secured claim may credit bid at a sale held by a debtor in a chapter 11 proceeding (a *"363 Sale"*) unless the court for cause orders otherwise.[2] Under the Bankruptcy Code, unless the debtor or another party in interest objects to a claim, a properly filed claim is deemed to be an allowed claim.[3]

The secured creditor's right to credit bid in a 363 Sale has long been a bedrock bankruptcy principle. However, in the *Philadelphia Newspapers case*, the debtors attempted to circumvent this provision by selling their assets pursuant to a plan of reorganization rather than pursuant to Section 363, arguing that a secured creditor's right to credit bid did not apply to a sale under a plan of reorganization. The Bankruptcy Court in *Philadelphia Newspapers* confirmed the debtor's plan and held that the secured creditor's right to credit bid did not apply to a sale under a plan of reorganization. The Third Circuit upheld the confirmation of the chapter 11 plan that denied the secured creditor the right to credit bid.[4]

In May of 2012, the Supreme Court seemingly ended the controversy engendered by *Philadelphia Newspapers* when it upheld the right of secured creditors to credit bid their debt at a sale of the secured creditor's collateral under a plan of reorganization.[5] The *RadLAX* decision effectively overturned the Third Circuit's decision in *Philadelphia Newspapers*.

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1 *In re Fisker Automotive Holdings, Inc., et al.*, Case No. 13-13087 (KG)(Bankr. D. Del. Jan. 17, 2014) [Docket No. 483].

2 *See* 11 U.S.C. § 363(k).

3 *See* 11 U.S.C. § 502(a).

4 *In re Philadelphia Newspapers*, LLC, 559 F.3d 298 (3d Cir. 2010).

5 *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012).

However, the *Fisker Automotive* case has reignited this controversy by challenging certain bedrock principles: (i) that a secured creditor may credit bid its entire claim in a 363 Sale unless "cause" is shown so as to disallow such credit bid; and (ii) that the price paid by a purchaser of a loan or claim is irrelevant to the amount of the creditor's claim and its right to enforce such claim.

Proposed Asset Sale and Committee's Objection

The facts in *Fisker Automotive* are not complicated and are similar to many other cases in which secured creditors seek to credit bid their secured claims. The senior secured creditor purchased approximately $169 million of secured debt from a third party for $25 million. The debtor then filed its chapter 11 case and sought court approval for a private sale of substantially all of its assets to the secured creditor pursuant to a 363 Sale. The consideration for the purchase included $75 million in the form of a credit bid, waiver of the remaining secured debt, assumption of certain liabilities and payment of additional cash.

The creditors' committee opposed the proposed sale and, in particular, the secured creditor's right to credit bid. The committee instead proposed a public auction with another party serving as the stalking-horse bidder. The committee argued that no credit bid should be allowed because it would chill bidding; in fact, the committee stated that there would be no auction at all if the secured creditor's ability to credit bid were not curtailed or capped, as the other interested bidder would not bid more than the amount of the secured party's secured claim.

The committee also raised concerns regarding the extent and validity of the secured creditor's liens and argued that no credit bid right existed where assets being sold included a mix of secured collateral, disputed collateral and unencumbered collateral.[6] As a fallback position, the committee suggested that any credit bid be capped at $25 million, the price the secured creditor paid to purchase the secured claim, because that amount was the best evidence of the value of the collateral securing the secured claim.

Limitation on the Right to Credit Bid

The Bankruptcy Court held that "cause" existed under Section 363(k) of the Bankruptcy Code to limit the secured creditor's right to credit bid for two reasons: (i) the desire to foster a competitive bidding process; and (ii) concerns raised by the committee regarding the extent and validity of the secured party's liens on some of the assets that were being sold. The Bankruptcy Court then capped the secured creditor's credit bid at $25 million, the purchase price for the secured claim.

The Bankruptcy Court appeared to be deeply concerned with the speed at which the proposed sale was proceeding and believed that the "drop-dead" date initially proposed by the secured creditor was fabricated and designed to put pressure on other creditors and the Court. In the Bankruptcy Court's view, the rush to sell the assets was "inconsistent with the notions of fairness in the bankruptcy process."[7]

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6 The collateral in dispute consisted primarily of (i) foreign intellectual property, (ii) approximately six vehicles in the U.S. and (iii) certain vehicles located in other countries.

7 *In re Fisker Automotive,* Case No. 13-13087 KG) (Bankr. D. Del. Jan. 17, 2014) at 10.

Denial of Appeal

The secured creditor immediately appealed the Bankruptcy Court's decision to the District Court and requested an expedited hearing on the appeal. On February 7, 2014, the District Court refused to hear the appeal, finding that the decision was not ripe for appeal because the Bankruptcy Court had not yet fully resolved the issue of the validity of the secured creditor's liens or how the proceeds of the auction would be distributed.[8]

In its February 7 ruling, the District Court confirmed the power of Bankruptcy Courts under the plain language of Section 363(k) to deny or limit a secured creditor's right to credit bid and stated that the desire to foster a competitive bidding environment was an appropriate reason for denying this right. In addition, the fact that the secured creditor could be reimbursed out of the proceeds of the auction, if it was ultimately determined that its credit bid should not have been capped, was sufficient reason for the District Court to deny hearing the appeal.

Issues and Concerns

The *Fisker Automotive* case is extremely troubling to secured creditors and purchasers of secured claims in the secondary market. Although only a small number of cases have directly addressed the issue of what constitutes "cause" under Section 363(k) of the Bankruptcy Code to limit or deny a secured creditor's right to credit bid, until now, courts that have denied this right have generally done so only in cases where secured creditors have engaged in misconduct or wrongdoing, or in instances where there have been bona fide disputes regarding the perfection of a secured creditor's liens.[9]

In almost any bankruptcy auction, the ability of a secured creditor to credit bid will, to a certain extent, chill bidding and in some instances may even obviate an auction if the secured claim greatly exceeds the perceived value of the assets. It is equally true that in many asset sales, there is a mix of secured collateral, disputed collateral and unencumbered collateral that is being sold, and there may be concerns or allegations regarding the extent and/or validity of the secured creditor's liens on various collateral. Courts have generally dealt with credit bids involving the sale of mixed assets by permitting the secured creditor to credit bid up to the full amount of the secured claim with respect to the secured collateral, but requiring that the secured creditor provide other consideration for collateral that is ultimately determined to be unencumbered. In some cases, where the value of the unencumbered collateral was unclear or where there was a legitimate dispute over whether the secured creditor was fully perfected, courts have ordered the secured creditor to indemnify the estate, post a letter of credit or guaranty, and/or pay a portion of the purchase price in cash if it was ultimately determined to be unsecured.

Fisker Automotive is the first case that we are aware of which held that the desire to foster an active auction or the voicing of a mere concern regarding the extent and validity of a secured creditor's liens, without more, was sufficient to constitute cause to limit a secured creditor's right to credit bid. Furthermore, capping the credit bid at an amount equal to the purchase price for acquiring the secured

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8 *In re Fisker Automotive Holdings, Inc. et al.*, Case No. 14-CV-99 (GMS)(D. Del. Feb. 7, 2014) [Docket No. 34].

9 Just recently, the Bankruptcy Court in the *Florida Gaming Centers* bankruptcy proceeding held that a secured creditor's credit bid could not include components of the creditor's claim that had been disallowed in a separate adversary proceeding and referred the parties to mediation to determine the amount the secured creditor would be allowed to credit bid. In re Florida Gaming Centers, Inc. et al., Case No. 13-29597 (RAM) (Bankr. Ct. S.D. Fla. Feb. 5, 2014) [Docket No. 305].

claim appears to contradict the fundamental principle that the price paid by a creditor for a claim has no bearing on the amount of the creditor's claim in bankruptcy. The holding in Fisker Automotive substantially lowers the bar for challenging what was once thought to be a basic right of secured creditors–the right to credit bid–and raises concerns for secured creditors and purchasers of secured claims in the secondary market.

May 13, 2014

Recent Challenges to Credit Bidding – A New Trend?

Two recent bankruptcy court decisions from the District of Delaware and Eastern District of Virginia raise serious concerns for secured lenders and purchasers of secured loans in the secondary market. These decisions capped the secured lender's right to "credit bid" (*i.e.*, to bid the amount of debt owed rather than cash) in a sale process commenced by a debtor pursuant to Section 363 of the Bankruptcy Code (a *"363 Sale"*). In the most recent case, Free Lance-Star,[10] the bankruptcy court limited the secured creditor's credit bid amount to $13.9 million, approximately one third of the face amount of the claim. This decision followed on the heels of Fisker Automotive,[11] which capped the secured creditor's right to credit bid its $169 million secured claim at the $25 million purchase price paid by the secured creditor for the secured claim.

While some view these decisions as limited to their unique facts, we disagree. Upon a closer examination, these rulings appear to break new ground from prior case law in their application of fundamental bankruptcy principles and significantly undermine the protections afforded secured creditors under the Bankruptcy Code. Therefore, purchasers of loans in the secondary market, especially those investors seeking to effect a "loan to own" strategy, and even original lenders seeking to exercise the right to credit bid in order to maximize their recovery, should be mindful of these decisions and how they may impact their rights to credit bid in 363 Sales.

Right to Credit Bid Prior to Fisker Automotive

The Bankruptcy Code in Section 363(k) provides that a holder of an allowed secured claim may credit bid its loans in a 363 Sale, unless the court for "cause" orders otherwise.[12] Prior to *Fisker Automotive*, only a small number of cases directly addressed the issue of what constitutes "cause" under Section 363(k) of the Bankruptcy Code. In those cases, "cause" was generally limited to cases where secured creditors engaged in misconduct.

For example, in *Aloha Airlines*,[13] the court denied the secured creditor the right to credit bid its loans because the secured creditor had entered into an intellectual property license with a competing airline that had sought to force the debtor out of business and had engaged in misconduct by improperly using the debtor's confidential information and destroying evidence. Similarly, in *Theroux*,[14] the court

10 *In re Free Lance-Star Publishing Co. of Fredericksburg, Va et al.*, Case No. 14-30315 (KRH) (Bankr. E.D. Va. Apr. 14, 2014) [Docket No. 185]. [Hereinafter, Free Lance-Star].

11 *In re Fisker Automotive Holdings, Inc. et al.*, Case No. 13-13087 (KG) (Bankr. D. Del. Jan. 17, 2014) [Docket No. 483]. [Hereinafter, Fisker Automotive].

12 *See* 11. U.S.C. § 363(k).

13 *In re Aloha Airlines, Inc.*, 2009 LEXIS 4588 (Bankr. D. Haw., May 14, 2009).

14 *In re Theroux*, 169 B.R. 498 (Bankr. D. R.I. 1994).

Michael Friedman, Larry G. Halperin, and Simone Tatsch, *Recent Challenges to Credit Bidding –A New Trend?*, 10 PRATT'S JOURNAL OF BANKRUPTCY LAW 441 (LexisNexis A.S. Pratt)

refused to approve the sale of assets to the secured creditor because the sale price was artificially set at 10% of the market value of the assets and the sale was designed to wipe out superior tax liens and to allow the secured creditor to retain for itself all of the value in excess of the credit bid amount.

Moreover, prior to *Fisker Automotive*, the price paid by a purchaser of a loan or claim was irrelevant to the amount of the creditor's claim and its rights to enforce such claim.

Finally, prior to *Fisker Automotive*, if issues were raised as to the scope or validity of a secured creditor's lien and such issues could not be resolved prior to the auction, courts would generally permit the secured creditor to credit bid up to the full amount of the secured claim with respect to the collateral, but would require the secured creditor to agree to pay cash or assume liabilities equal to the value of any unencumbered assets ultimately determined to have been included in the credit bid.

The Recent Cases Limiting Credit Bidding

Fisker Automotive.

As mentioned in our previous alert on this topic,[15] the court in *Fisker Automotive* ruled that "cause" existed under Section 363(k) of the Bankruptcy Code to limit the secured creditor's right to credit bid its $169 million secured claim to the $25 million paid for such claim. Relying on a footnote in dicta from the *Philadelphia Newspapers*[16] decision that

> a court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment,

the court found that "cause" existed due to: (i) the desire to foster a competitive bidding process, and (ii) concerns raised by the unsecured creditors committee regarding the extent and validity of the secured creditor's liens on some of the assets that were being sold.

In addition, the Bankruptcy Court was deeply concerned with the speed at which the proposed sale was proceeding and believed that the secured creditor's actions were designed to put pressure on other creditors. The Court thus determined that the rush to sell the assets was "inconsistent with the notions of fairness in the bankruptcy process."[17]

Free Lance-Star Case

Clearly influenced by *Fisker Automotive*, the bankruptcy court's decision in *Free Lance-Star* also significantly limited the secured creditor's right to credit bid. In *Free Lance-Star*, the secured creditor purchased an existing loan in the amount of $50.8 million. In January 2014, approximately seven months after the purchase of the loan, the Company and one of its affiliates (collectively, the "*Debtors*") commenced bankruptcy proceedings and filed two motions to sell their assets and establish bidding procedures for such sales. The first motion related to the sale of operating assets, which the Debtors

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15 *See* "New Challenge to Credit Bidding – Distressed Debt Purchasers Beware" (February 12, 2014) http://www.chapman.com/insights-publications-254.html

16 *In re Philadelphia Newspaper, LLC*, 539 F.3d 298 (3d Cir. 2010).

17 *In re Fisker Automotive Holdings, Inc. et al.*, Case No. 13- 13087 (KG) (Bankr. D. Del. Jan. 17, 2014) at 10.

confirmed were covered by the secured creditor's liens.[18] The second motion related to the sale of certain *"Tower Assets"* (*i.e.*, certain real property, equipment, permits, related insurance policies and other rights), which assets, the Debtors argued, were not covered by the secured creditor's liens.[19]

In March 2014, the Debtors filed a motion to limit the secured creditor's credit bid to the amount paid by the secured creditor to purchase the debt and to prevent the secured creditor from credit bidding on the Tower Assets, certain motor vehicles and other assets.[20] The Official Committee of Unsecured Creditors filed a memorandum in support of the Debtors' motion.

On April 14, 2014, the Bankruptcy Court entered an order limiting the secured creditor's right to credit bid its $38 million secured claim to $13.9 million.[21] The court concluded that

> [t]he confluence of (i) [the secured creditor's] less than fully secured lien status; (ii) [the secured creditor's] overly zealous loan to own strategy; and (iii) the negative impact of [the secured creditor's] misconduct has had on the auction process has created the perfect storm, requiring curtailment of [the secured creditor's] credit bid rights.

As evidence of the secured creditor's "inequitable conduct", the court pointed to (i) the secured creditor's request for new liens on the Tower Assets as adequate protection for the Debtors' use of cash collateral without disclosing to the court that it had already recorded financing statements against such assets prior to the bankruptcy filing which had been done without the knowledge of the Debtors and without obtaining court approval; (ii) the secured creditor's efforts to "frustrate" the competitive bidding process by asking the Debtors to add to the marketing materials that the secured creditor would be entitled to credit bid at the amount of approximately $39 million and (iii) the secured creditor's pursuit of a "loan-to-own" strategy that depressed enthusiasm for the bankruptcy sale in the marketplace.[22]

The Bankruptcy Court also held that the secured creditor did not have a valid and properly perfected lien on all the assets being sold and, therefore, the "credit bid amount must be configured to prevent [the secured creditor] from credit bidding its claim against assets such as the FCC licenses that are not within the scope of its collateral pool."[23]

Because the secured creditor did not disclose the purchase price paid for its claim, the $13.9 million credit bid cap determined by the court was based on an analysis by the Debtors' financial advisor that was focused on what cap was appropriate in order to "foster a competitive auction process".[24]

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18 *Free Lance-Star* [Docket No. 17].

19 *Free Lance-Star* [Docket No. 18].

20 *Free Lance-Star* [Docket No. 122].

21 *Free Lance-Star* [Docket No. 185].

22 *Free Lance-Star* [Docket No. 185 at 13].

23 *Free Lance-Star* [Docket No. 185 at 145].

24 *Free Lance-Star* [Docket No. 185 at 14].

Impact of Fisker Automotive and Free Lance-Star – Breaking New Ground

Fostering Competitive Auction as Cause

The recent decisions break new ground by interpreting "cause" in Section 363(k) of the Bankruptcy Code to limit a secured creditor's credit bid right when it is determined that capping or limiting the right to credit bid will foster a sale process that is "robust", "competitive" and "open" to maximize value for creditors of the estate. In addition, both decisions focused on the purchasers' pursuit of a "loan to own" investment strategy to justify the limitation on the right to credit bid.

Historically, courts limited "cause" to clearly egregious conduct by the secured creditor and not just to the fact that credit bidding could chill bidding in the 363 Sale. Thus, in *Aloha*,[25] the court denied the right to credit bid where the secured creditor partnered with a competitor seeking to force the debtor out of business. Similarly, the court in *Theroux*[26] refused to approve a sale to a secured creditor that had colluded with a trustee to purchase the assets at a fraction of market value in order to wipe out superior liens on the property and reap all of the excess value for itself. Although one may argue that the secured creditors in *Fisker Automotive* and *Free Lance-Star* were perhaps aggressive in pursuit of their contractual remedies under the loans, it would be hard to compare such conduct to the types of conduct that would have amounted to "cause" in the cases decided prior to *Fisker Automotive*.

This broad interpretation of "cause" to include fostering a competitive auction is troubling as the existence of a credit bid always has some chilling effect on a 363 Sale. This is because potential bidders do not know the price at which the secured lender will allow the assets to be sold to another bidder and forego its right to credit bid. Courts have always been required to balance this potential chilling effect against the protections afforded secured creditors under Bankruptcy Code Section 363(k) not to be forced to accept an unacceptable price for its collateral. Courts were content to reduce the risk of chilling the bid by ensuring that bidding procedures provided for a sufficient marketing period with adequate marketing materials and a fair and level playing field.

Courts have long recognized that, as long as the ultimate value of the collateral does not exceed the secured claim, the risk of a chilled bid would be borne by the secured creditor. Unsecured creditors or equity holders would only become relevant if the market value exceeded the amount of the secured claim. In fact, in *Fisker Automotive*, despite the capping of the credit bid in order to foster a robust auction, the winning bid in the auction did not exceed the $169 million secured claim.

Focus on Valuing Lien by Looking to Unencumbered Assets and Purchase Price

The reliance by *Fisker Automotive* and *Free Lance-Star* decisions on the existence of unencumbered (or in the case of *Fisker Automotive*, the mere allegation of the existence of unencumbered) assets to justify limiting the secured creditor's credit bid rights is also a departure from the prior case law. These courts could have fashioned a remedy that would have allowed the secured creditor to credit bid, but would have also required the provision of alternate consideration to the extent it was ultimately determined that some of the assets subject to the credit bid were unencumbered. Instead, the *Fisker Automotive* and *Free*

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25 *In re Aloha Airlines, Inc.*, 2009 LEXIS 4588 (Bankr. D. Haw., May 14, 2009).

26 *In re Theroux*, 169 B.R. 498 (Bankr. D. R.I. 1994).

Lance-Star decisions used concerns regarding the validity, perfection and value of the liens to justify restricting credit bid rights.

Fisker Automotive's and *Free Lance-Star's* focus on the purchase price paid to acquire the secured claim is also troubling. In *Fisker Automotive*, the court used the price paid for the claim as evidence of the value of the collateral and capped the amount of the credit bid at the purchase price or $25 million, notwithstanding the asserted claim of $169 million. Similarly, the court in *Free Lance-Star* was disturbed that the secured creditor refused to divulge its purchase price for the secured claim, clearly indicating that, had it been provided with such information, it would have been used to determine the cap on the secured creditor's credit bid rights. The focus on the value of encumbered assets and on the purchase price paid to acquire the secured claim represents a clear departure from two bedrock bankruptcy principles: (i) the price paid by a purchaser of a loan or claim bears no relationship to the amount of the creditor's claim in bankruptcy or the value of its lien and (ii) the value of a secured party's lien for purposes of credit bidding should be determined by the highest and best bid at the auction whether in cash or by credit bid and not in a court hearing prior to the auction. Putting a court-determined value on a lien in order to cap the secured creditor's credit bid undermines the very protections Section 363(k) was designed to afford – that a secured party unsatisfied with the highest bid obtained during an auction could elect to acquire its collateral in exchange for its loans.

Conclusions

By (i) significantly expanding "cause" to include fostering a competitive auction process, (ii) conflating the scope and validity of the lien and the value of the lien and (iii) introducing the price paid by the secured creditor for the secured claim as a factor in determining the credit bid amount, these decisions undermine the basic protections afforded secured creditors through the right to credit bid to ensure that their collateral will not be undervalued and that a secured creditor will not be forced to accept a recovery less than the amount of its loans.

These recent decisions are problematic for secured creditors because: (i) in some cases, such as public bondholders or a large syndicate of lenders, it may not be possible for lenders to fund a cash bid for the collateral in an auction and (ii) requiring the secured creditor to cash bid could result in a significant shift in leverage to the unsecured creditors because the cash will not be disbursed to the secured creditor, but rather will remain in an escrow account pending the resolution of claims asserted by the unsecured creditors against the secured creditor's liens and claims. The longer this resolution takes, the greater the leverage to the unsecured creditors. In fact, the unsecured creditors in *Fisker Automotive* likely benefitted from such leverage in being able to negotiate a $20 million settlement from the secured creditor despite the fact that the winning bid in the auction did not exceed the $169 million secured claim.

In view of these groundbreaking cases, more than ever, secured creditors must:

- diligence the validity and perfection of their liens;
- be proactive in offering non-credit bidding consideration (*i.e.*, cash or assumption of liabilities) to the extent they are seeking to acquire unencumbered assets; and
- avoid seeking overly aggressive timetables or constraints on the debtors' ability to fully and appropriately market the assets being sold.

Such prudent measures are especially sensible in light of the current debate among lawyers, judges and scholars whether fundamental changes should be made in the way secured creditors are permitted to effect remedies and control bankruptcy cases. Secured creditors and secondary purchasers must, therefore, be more vigilant than ever as everything from the validity of their liens to their pre-petition and post-petition conduct is more likely to be heavily scrutinized to determine whether the secured creditor was using its leverage to depress a competitive marketing and auction process.

July 18, 2014

Make-Whole Provisions Continue to Cause Controversy: What You Can Do to Avoid Litigation

Given today's low interest rate environment, the enforceability of make-whole provisions has been the subject of intense litigation as debtors seek to redeem and refinance debt entered into during periods of higher interest rates, and investors seek to maintain their contractual rates of return. This trend has come to the forefront most recently in two separate cases, one filed in Delaware and the other in New York. In Energy Future Holdings, the first-lien and second-lien indenture trustees have each initiated separate adversary proceedings in Delaware bankruptcy court claiming the power company's plan to redeem and refinance its outstanding debt entitles the respective holders to hundreds of millions of dollars in make-whole payments.[27] Conversely, In MPM Silicones, LLC, it is the debtors that have sought a declaratory judgment from the New York bankruptcy court that, on account of an automatic acceleration upon the bankruptcy filing, no make-whole payment is required to be paid.[28] Given the frequency which make-whole disputes have arisen and the enormous sums at stake, it is important for all investors to understand the various arguments for and against payment of a make-whole premium, and the specific issues to look for when analyzing debt containing make-whole provisions. Despite the various legal arguments that exist, the single most important factor will always be the specific language of the applicable credit agreement or indenture.

Make-Wholes Generally

Credit documents often contain express make-whole provisions to offer yield protection to investors in the event of a repayment of a loan prior to the agreed upon maturity. Such provisions allow parties to agree in advance on a measure of damages for such prepayment. Lenders use make-wholes to lock in a guaranteed rate of return on their investment at the time they agree to provide the financing. Borrowers typically benefit from such provisions by obtaining lower interest rates or fees than they would otherwise absent such protections.

Make-Whole Arguments

For the most part, disputes regarding the enforceability of a make-whole provision center around the following arguments: (i) does the contractual language of the relevant credit agreement provide for payment of the make-whole; and, if so, (ii) has a bankruptcy filing or other default accelerated the debt, causing it to be already due and payable, thereby negating the requirement to pay a make-whole payment.[29] Other lesser arguments that may be raised include: (i) whether the make-whole represents an

27 *In re Energy Future Holdings Corp.,* Adversary Proceeding No 14-50363 (with respect to the first-lien notes) and Adversary Proceeding No 14-50405 (with respect to the second-lien notes). In an attempt to resolve the make-whole issues, debtors have previously proposed a tender offer to repurchase both the first-lien and second-lien notes.

28 *In re MPM Silicones, LLC*, Adversary Proceeding No. 14-08227.

29 See, e.g., *In re Sch. Specialty, Inc.*, 2013 WL 1838513 at *4 (Bankr. D. Del. Apr. 22, 2013).

unenforceable penalty under applicable state law, (ii) does the make-whole represent a claim for unenforceable unmatured interest under § 502(b)(2) of the Bankruptcy Code, (iii) whether the make-whole represents a secured or unsecured claim, and (iv) whether the make-whole amount is unreasonable.

Does the Relevant Agreement Include a Make-Whole?

Because make-whole provisions are creatures of contract and not of law, to be effective (and to provide for a secured claim), these provisions must be contained in the applicable loan documents. In determining whether a proposed debt repayment triggers a make-whole claim, courts first consider whether the lender is entitled to a make-whole claim under the relevant contract as a matter of state law. Whether a make-whole is due depends principally on the plain language contained in the applicable bond indenture or credit agreement.[30] Courts also look to such language to determine the amount of any make-whole payment.

Does the Indenture Provide for Payment Following an Acceleration?

While make-whole amounts are typically triggered by an early repayment prior to maturity, most credit documents provide that the outstanding debt automatically accelerates and thereby becomes immediately due and payable upon a bankruptcy filing. Make-whole clauses may be held ineffective following an automatic acceleration, as certain courts have held that there cannot be any "prepayment" following a debt's deemed maturity upon acceleration.[31] Numerous courts have, however, held that a make-whole is still payable provided that the applicable credit agreement provides for such payment following an acceleration. In two recent cases, *In re School Specialty, Inc.*[32] and *In re GMX Resources, Inc.*,[33] the bankruptcy courts found that the governing agreements specifically provided for payment of the make-whole premium notwithstanding a bankruptcy-related acceleration. In contrast, in *In re AMR Corp.*, the bankruptcy court, which was later affirmed by the U.S. Court of Appeals for the Second Circuit, found the contractual language of the relevant indentures provided that no make-whole payment was due following an automatic acceleration.[34]

Whether an acceleration has occurred and its effect on the make-whole is at the center of both the *Energy Future Holdings* and *MPM Silicones* disputes. With respect to the *Energy Future Holdings* first-lien notes, the indenture trustee has alleged that the applicable indenture contains no carve-out from payment

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30 See, e.g., In re Calpine Corp., 2010 WL 3835200, at *4 (S.D.N.Y. Sept. 15, 2010) (lenders not entitled to make-whole because the plain language of the debt instruments did not provide for the payment following an acceleration); In re Solutia, Inc., 379 B.R. 473, 485 n.7 (Bankr. S.D.N.Y. 2007) (court refused to "read into agreements between sophisticated parties provisions that are not there," and held that no make-whole amount was due).

31 *See In re LHD Realty Corp*., 726 F.2d 327, 330-331 (7th Cir. 1984) ("acceleration, by definition, advances the maturity date of the debt so that payment thereafter is not prepayment but instead is payment made after maturity."); In re Premier Entm't Biloxi LLC, 445 B.R. 582, 625-27 (Bankr. S.D. Miss. 2010) (noteholders had no contractual right to prepayment premium where indenture provided for automatic acceleration of notes upon default arising from debtors' bankruptcy filing rendering the notes mature at time of their repayment as part of consummation of debtors' confirmed chapter 11 plan).

32 *In re Sch. Specialty, Inc.*, 2013 WL 1838513 at *4 (Bankr. D. Del. Apr. 22, 2013).

33 In *In re GMX Resources, Inc.*, No. 13-11456 (Bankr. W.D. Ok. filed Apr. 1, 2013), the bankruptcy court found the first-lien lenders' claim properly included a make-whole premium of approximately $66 million and represented a legitimate liquidated damage provision, not unmatured interest subject to disallowance under section 502(b)(2) of the Bankruptcy Code, and Bankruptcy Code section 506(b)'s reasonableness standard did not apply.

34 *In re AMR Corp.*, 485 B.R. 279, 294 (Bankr. S.D.N.Y. 2013); *In re AMR Corp.*, 730 F.3d 88, 103 (2d Cir. 2013).

of the make-whole upon an acceleration. Furthermore, the first-lien indenture trustee alleges that any acceleration can be rescinded by the holders. In its complaint, the *Energy Future Holdings* second-lien trustee has asserted that: (i) the debt was not accelerated, and (ii) if such debt was accelerated, the underlying credit agreements provide for payment of all principal, interest and "premium, if any" notwithstanding acceleration. In *MPM Silicones*, debtors' complaint alleges that no optional redemption can occur as the bankruptcy filing immediately accelerated the notes, accelerating the maturity date and making the outstanding amounts immediately due and payable. The *MPM Silicones* trustee has asserted a counterclaim seeking payment of the make-whole, alleging that payment is required pursuant to the indenture notwithstanding the acceleration. Whether such amounts are due and owing in these three cases will therefore depend in each instance on the judge's interpretation of the applicable contractual language, and specifically, whether an acceleration has occurred and, if so, whether the applicable indentures provide for payment of the make-wholes despite such acceleration.[35] Such contract language will also determine, among other things, the applicable rate of interest, whether default interest is due and what fees and expenses must be paid by the debtors.

Other Considerations

There are a number of other arguments debtors may attempt to use to negate a make-whole provision. These include claiming that such payments are for "unmatured interest," which is not allowed under the U.S. Bankruptcy Code, or by arguing that the make-whole amount was a penalty or plainly disproportionate to the claimants' loss. These arguments are of limited merit as make-whole provisions have typically been held to be valid liquidated damage provisions enforceable as a matter of state law.[36] Similarly, courts have typically dismissed arguments that the make-whole payment was not reasonable under § 506(b) of the Bankruptcy Code, which only allows a secured creditor to recover, in addition to the amount of its secured claim, "reasonable" fees, costs and charges. In fact, in *School Specialty,* the amount of the make-whole premium represented 37 percent of the loan principal.[37] In that instance, the court held that because the make-whole provision was a valid liquidated damages clause, no "reasonableness" examination under § 506 was required, but that even if the make-whole premium had to pass a "reasonable" test, the court would have approved it.[38]

Is the Claim Secured?

Whether a claim is deemed a secured claim is determined initially under § 506(b) of the Bankruptcy Code which provides that a claim may be secured so long as it "is secured by property the value of which … is greater than the amount of such claim…." Thus, a secured claim can only exist up to the value of the collateral. It is important to note that to the extent that a lender's claim, including the make-whole, exceeds the collateral's value, any such amounts over the collateral's value will be an unsecured claim.

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35 *See In re AE Hotel Venture*, 321 B.R. 209, 219 (Bankr. N.D. Ill. 2005) ("Because the loan documents here expressly provide for a prepayment premium even when the debt is accelerated" the premium was approved).

36 *See In re Trico Marine Servs., Inc.*, Case No. 10-12653 (Bankr. D. Del.) (BLS) (Opinion dated April 15, 2011) (the Delaware bankruptcy judge held: "The substantial majority of courts considering this issue have concluded that make-whole … obligations are in the nature of liquidated damages rather than unmatured interest …").

37 *In re Sch. Specialty, Inc.*, 2013 WL 1838513 at *4.

38 *Id.* at *5.

Can the Acceleration be Waived?

In *Energy Future Holdings*, the first-lien trustee alleges that even if the debt was accelerated, such acceleration can be rescinded by the holders. Creditors have previously attempted to argue that they are entitled to waive such contractual acceleration occurring following a bankruptcy filing. However, courts have generally held any such waiver to be an action to exercise control over the property of the estate and a violation of the automatic stay.[39]

What to look for in Make-Whole Provisions

- As in any contract provision, when examining a make-whole provision, parties should seek clear and unambiguous terms specifying the situations in which lenders are entitled to their bargained-for make-whole payment.
- Loan agreements should provide that a make-whole amount is due regardless of any acceleration or action taken by lender to protect its rights.
- The manner of calculating the make-whole should be based upon actual damages accruing to the lender (many make-whole calculations are based upon the present value of the difference between the agreed interest rate and an interest rate based on LIBOR or Treasury Notes or Bonds, though other formulations are possible).
- Loan agreements should expressly state that the make-whole is a liquidated damages provision, not a claim for unmatured interest or a penalty, and that the make-whole amount represents a reasonable forecast of the damages caused by prepayment.
- To ensure that a secured claim exists, the make-whole amount should be included within definition of secured collateral and in all lien instruments.
- Another important issue is whether the provision at issue is a make-whole or a no-call provision. This issue is significant. Unlike make-wholes that allow for pre-payment upon the payment of a fee, "no-call" provisions specifically prohibit the borrower from prepaying the loan before maturity or before a specified date. While almost all bankruptcy courts hold that no-call provisions are not enforceable in bankruptcy, thereby allowing debtors to pay-off amounts prior to their maturity, courts are generally split over whether a debtor's repayment during a no-call period gives rise to a claim for damages. An important consideration, however, is that due to § 506(b), no secured claim for a no-call breach will exist unless the credit agreement specifically provides the measure of damages for such a breach.

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39 *See In re Solutia*, 379 B.R. at 484; *In re AMR Corp.*, 730 F.3d at 103 (Second Circuit affirmed bankruptcy court's conclusion that any attempt by the indenture trustee to waive the event of default and decelerate the debt would be a violation of the automatic stay).

September 4, 2014

I'm a Secured Creditor so I'm Entitled to Default Interest, *Right*?

As prices for distressed loans have risen, holders of secured claims are focusing not only on the recovery of principal but also on repayment of interest, fees and pre-payment-premiums or "make whole" payments. As we discussed in our prior client alert entitled *Make-Whole Provisions Continue to Cause Controversy: What You Can Do to Avoid Litigation*, whether or not a secured creditor is entitled to a make-whole premium is primarily dependent on the contractual language in the credit agreement or indenture and the facts surrounding the repayment of the debt obligations. Similarly, whether or not secured creditors are entitled to claim default interest will depend on several factors, including the language in the loan agreement, the value of the collateral securing the loan, the nature of the default triggering the right to default interest and the equities of the case. This alert discusses the primary questions secured creditors should ask in determining whether their claim for default interest is likely to be allowed.

Am I Entitled to Default Rate Interest Accrued Prior to the Bankruptcy Filing?

In analyzing any claim for default interest, the first determination should be whether the interest at issue was incurred prior to, or following, a bankruptcy filing. This is important as courts consistently allow pre-petition default interest at the rate provided for in the underlying agreement as part of a secured claim.[40] Further, unlike claims for post-petition default interest, there is no "equitable" test with respect to pre-petition default rate interest.[41] Even if the court believes that the default rate is high, it typically will not alter the unambiguous terms of an agreement that was negotiated by sophisticated parties at arm's length unless there is clear evidence of overreaching by the lender.[42]

Am I Entitled to Default Rate Interest Accruing After a Bankruptcy Filing?

Before analyzing secured creditors' rights to claim default rate interest following a debtor's commencement of a bankruptcy proceeding, it is important to understand the general rule regarding the accrual of non-default rate interest following a bankruptcy filing. Generally, secured creditors are entitled to accrue post-petition interest in two instances: (i) to the extent the secured creditor is oversecured (*i.e.*,

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40 *See In re Milham*, 141 F.3d 420, 423 (2d Cir. 1998) ("Prepetition interest is generally allowable to the extent and at the rate permitted under the applicable nonbankruptcy law, including the law of contracts.").

41 *In re 785 Partners LLC*, 470 B.R. 126, 131 (Bankr. S.D.N.Y. 2012); *In re Northeast Industrial Dev. Corp.*, Case No. 13-37619 at p. 29 (Bankr. S.D.N.Y. July 29, 2014) (finding that equitable considerations should not be taken into account when dealing with prepetition interest claims).

42 *In re 785 Partners LLC,* 470 B.R. at 132 ("[e]ven where the default rate strikes the judge as high [in this case 10%], a court cannot rewrite the parties' bargain based on its own notions of fairness and equity."); *In re 400 Walnut*, 473 B.R. 603, 610 (2012) (allowing 16% interest rate).

creditor's claims are secured by collateral having a value exceeding the amount of the claim)[43] and (ii) when the claim is asserted against a solvent debtor.

To the extent a secured creditor satisfies one or both of these requirements, in determining whether a secured creditor is entitled to a default rate of interest, bankruptcy courts have required a further "equitable" review to determine whether: (i) there has been creditor misconduct; (ii) application of the default interest rate would harm unsecured creditors; (iii) the default interest rate constitutes a penalty; or (iv) application of the default interest rate would impair the debtor's "fresh start."[44] When these factors are absent, courts are reluctant to modify private contractual agreements concerning post-petition default interest rates and will typically allow the claim.[45]

Whether a claim for default interest will be disallowed upon equitable grounds will largely depend on the facts of the specific case. For example, courts will not likely find evidence of misconduct simply because a creditor has asserted its rights or raised objections to a debtor's motions.[46] Courts will also typically not find default interest to harm unsecured creditors where the debtor is solvent and all creditors are being paid in full.[47] If a debtor is liquidating, courts may not find that payment of default interest would interfere with a debtor's "fresh start."[48]

Although courts typically will not find default interest to be an impermissible penalty when it is included in a credit agreement that has been negotiated at arm's length by sophisticated parties, at least one court has held that the default rate was an unenforceable penalty where the loan agreement provided for a 25% default interest rate, finding that its application would be inequitable as the spread between the non-default and default rates was "significant and unexplained," the enforcement of the default rate would adversely affect creditors of the insolvent estate and, because the debtor cured the default under its plan, all of the consequences of the default were eliminated.[49]

In addition, where payment of default interest would result in a sizeable reduction in distributions to unsecured creditors, or possibly prevent the debtor from confirming a plan, courts have denied such claims upon equitable grounds.[50] However, in an important recent decision arising from the *Residential Capital* case, the bankruptcy court in the Southern District of New York held that even though the debtor was insolvent and unsecured creditors' recovery would be reduced, the payment of $5 million in default rate interest to an oversecured creditor was allowed, finding that allowing such claim would only diminish the pool of distributable assets to unsecured creditors by 0.2%, and that the financing provided by the lender had greatly assisted the debtors, resulting in a benefit to the unsecured creditors. While largely fact specific, the *Residential Capital* decision should support secured creditors' attempts to

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43 *Section 506(b) of the Bankruptcy Code provides that an oversecured creditor is entitled to "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement … under which such claim arose." 11 U.S.C. § 506(b).*

44 *In re Gen. Growth Properties, Inc.*, 451 B.R. 323, 328 (Bankr. S.D.N.Y. 2011).

45 *Id*. at 328.

46 *See In re SW Boston Hotel Venture, LLC,* 748 F.3d 393, 415 (1st Cir. 2014).

47 *See General Growth Properties, Inc.*, 451 B.R. at 328 (court determined that, because the debtor was "exceedingly solvent," payment of default interest would neither inflict harm on other unsecured creditors nor impair the debtors "fresh start.").

48 *See In re Sultan Realty, LLC*, 2012 WL 6681845 (Bankr. S.D.N.Y. Dec. 21, 2012).

49 *In re Bownetree*, LLC, 2009 WL 2226107 (Bankr. E.D.N.Y. July 24, 2009).

50 *See General Growth,* 451 B.R. at 326; *In re Campbell,* 2014 WL 3734693 (Bankr. S.D.N.Y. July 29, 2014) (denying default interest on equitable grounds in the chapter 13 context).

recover default interest where they are able to demonstrate that any harm incurred by unsecured creditors as a result of the payment of default interest is limited and the secured financing assisted in the debtor's reorganization.

If I Am Entitled to Default Interest, What Rate Will a Court Apply?

The great majority of courts have held that the applicable default rate specified in the loan agreement should govern. On the other hand, courts will not insert a default rate into an agreement where not previously present.[51] Although the debtor generally bears the burden of rebutting the presumptive "contract rate," contract rates may be rebutted if the debtor demonstrates that there is no justification for the high rate and the rate is "inordinately high in relation to the non-default rate."[52]

Courts tend to either grant default interest at the rate specified in the underlying agreement or deny the request in full, but courts rarely determine a different applicable rate on their own where a specific rate has been previously agreed to between the parties.[53] Where an objection is asserted against payment, as part of its equitable review, courts often require an evidentiary hearing to determine the rate's commercial reasonableness.[54]

Does it Matter What Type of Default Triggers the Right to Default Interest?

While it may be self-evident to state that default interest may only occur following an event of default, the specific type of default and the contractual default mechanics may have a profound effect on whether default interest will be allowed. For example, to the extent that declaring a default and acceleration is not automatic and the creditor fails to make an election prior to a bankruptcy filing, courts have held that the automatic stay will prohibit a creditor from delivering or rescinding default notices and no default interest will be due.[55]

In addition, some courts have denied default interest when the only existing default is the actual filing of the bankruptcy petition itself, holding that, pursuant to § 365(e) of the Bankruptcy Code, such defaults are impermissible *ipso facto* clauses and not capable alone of invoking the contract default interest rate.[56] For instance, the Bankruptcy Court in *Residential Capital* declined to grant post-petition interest at the default rate for the 16 day period between the debtors' May 14 bankruptcy filing date and the loan's May 30 maturity date because the debtor had been current on the loan upon the petition date. While the court did not allow for default interest to accrue solely on account of the bankruptcy filing, it did provide for interest to commence accruing following the default resulting from debtor's failure to pay

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51 *See Gen. Electric Capital Corp. v. Future Media Prods. Inc.*, 536 F.3d 969, 974 (9th Cir. 2008); *In re Vest Associates*, 217 B.R. 696, 702-03 (Bankr. S.D.N.Y. 1998); *In re Dow Corning Corp.*, 456 F.3d 668, 679-80 (6th Cir. 2006), *citing In re Southland Corp.*, 160 F.3d 1054, 1059-60 (5th Cir. 1998); *In re Woodmere Invs. Ltd. P'ship*, 178 B.R. 346, 355 (Bankr. S.D.N.Y. 1995).

52 *See In re Vest*, 217 B.R. at 702.

53 But *see, In re Haldes,* 503 B.R. 441, 447 (Bankr. N.D. Ill. 2013) (court held that creditor failed to provide any analysis to substantiate a 16.25% contract default rate; rate reduced by court to 10.25% based on average commercial lending rate).

54 *See, e.g., In re Lighthouse Lodge LLC*, 2010 WL 4053984 at *5 (N.D. Cal. Oct. 14, 2010).

55 *See In re Payless Cashways, Inc.*, 287 B.R. 482 (Bankr. W.D. Mo. 2002) (absent some affirmative action to accelerate debt, creditor could not charge default interest rate).

56 *See In re IT Group, Inc.*, 302 B.R. 483, 487 (D. Del. 2003); *In re Bownetree,* 2009 WL 2226107 at *2–3.

the underlying debt on the maturity date. Other courts, such as *General Growth,* however, have come to different conclusions and allowed for payment of default interest commencing on the petition date on account of the bankruptcy filing.

In most instances, these decisions appear to turn upon whether the underlying credit agreement is deemed an executory contract (where both, not one, of the parties have remaining obligations outstanding), as the prohibition against *ipso facto* clauses applies only to executory contracts. For instance, a revolving loan may be deemed to be an executory contract because both the lender and borrower have remaining obligations, whereas a fully funded term loan or bond indenture may be deemed to be non-executory because the lender may have fulfilled all of its obligations. Where, as in *General Growth,* a credit agreement is determined to be non-executory, courts have allowed claims for default interest to begin accruing on the petition date. However where, as in *Residential Capital,* the agreement is deemed to be executory, courts have only allowed default interest to begin accruing after a separate default occurs.

Am I Entitled to Default Interest on the Entire Principal Balance?

Although in most circumstances, a secured creditor should be entitled to a claim for default interest on the entire principal balance, secured creditors should be aware of several potential limitations. As mentioned above, to the extent a loan agreement does not provide for the automatic acceleration of the loan upon a bankruptcy filing, the secured creditor's right to claim default interest may be limited. Thus, in *Northwest Airlines*,[57] the court held that because lender had not accelerated the debt prior to the bankruptcy filing and the loan agreement did not contain an automatic acceleration provision upon a bankruptcy filing, the lender did not have the right to charge default interest on the entire loan amount and allowed default interest to accrue only on the unpaid installments.

In addition, at least one court has held that secured creditors may claim default rate interest only to the extent that they can present clear evidence of their oversecured status for the entire period that interest is sought.[58] In *SW Boston*, the debtor owned real estate upon which Prudential held a security interest. The debtor sold the property during the bankruptcy proceeding at a price greater than Prudential's secured claim and all parties agreed that Prudential was oversecured following the sale. The court was asked whether default interest should be paid for the pendency of the bankruptcy case (*i.e.* treating Prudential as oversecured for the whole case) or whether it should only be treated as oversecured for the post-sale period. After several appeals, the First Circuit held that, because Prudential failed to provide any evidence to meet its burden of showing that it was oversecured for the entire pendency of the case, Prudential was only entitled to default interest from the date of the sale until confirmation of the debtor's plan of reorganization.[59]

Am I Entitled to Allowance of Late Payment Premiums?

Although credit agreements sometimes require the payment of both default interest as well as late payment charges and other type of fees following a default, it is well-established that an oversecured creditor may receive payment of either default interest *or* late charges, but not both.[60] Secured creditors

57 *In re Northwest Airlines Corp.*, 2007 WL 3376895 (Bankr. S.D.N.Y. Nov. 9, 2007).

58 *In re SW Boston Hotel Venture, LLC.*, 748 F.3d at 411.

59 *Id.* at 410.

60 *See In re 785 Partners LLC,* 470 B.R. at 137; *In re 1095 Commonwealth Ave. Corp.,* 204 B.R. 284, 305 (Bankr. D. Mass. 1997).

should be careful to elect the type of fee or interest that is preferable at the commencement of a case, as any choice will likely be difficult to change later.[61]

Conclusion

Secured creditors or purchasers of secured claims should not assume that their claims will include default rate interest. Rather, whether secured creditors will receive default rate interest as part of their allowed claim is dependent on the relevant facts and circumstances, including the language of the credit agreement, the rate of interest and the nature of the default giving rise to the default rate interest. The allowance of default rate interest may also be dependent on the impact of such allowance on unsecured creditors. Therefore, legal and factual due diligence may be necessary to more accurately predict the likelihood that default rate interest will be allowed.

61 *See In re Sagamore Partners, Ltd.*, 512 B.R. 296, 318 (S.D. Fl. 2014).

September 29, 2014

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*[62] 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,"[63] 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,

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62 *In re MPM Silicones*, LLC, et al., Case No. 14-22503-RDD (Bankr. S.D.N.Y. Aug. 26, 2014).

63 *Id*. at 77:1-3.

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.[64] 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.[65]

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*.[66]

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.[67] 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.*[68] and the Second Circuit's decision in *In re Valenti*,[69] both of which specifically addressed the requirements of the present value test, albeit in a chapter 13 (consumer bankruptcy) context.

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64 *In re MPM Silicones, LLC,* Adversary Proceeding No. 14-08227.

65 Transcript (*"Tr."*) at 63:23-64:7.

66 11 U.S.C. 1129(b)(2)(A)(i) (emphasis added).

67 "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.

68 541 U.S. 465 (2004).

69 105 F.3d 55 (2d Cir. 1997).

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.[70] 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."[71] 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.[72]

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.[73]

Again, following both *Till* and *Valenti*, the Court held that, "generally speaking, that risk adjustment should be between one percent and three percent."[74]

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.[75]

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70 Tr. at 67:6-11.

71 *Id*.

72 *Id*. at 67:12-16.

73 *Id*. at 68:5-10.

74 *Id*. at 68:10-12; 77:2-3.

75 *Id*. at 83:20-84:3.

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.

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