Views from the Bench, 2018

American Bankruptcy Institute

Great Debates

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Resolved: Under *Till v. SCS Credit Corp.*, a bankruptcy court is required to use a two-step approach to determine the cramdown interest rate, and must first determine whether there is an efficient market before it can use the formula approach.

Pro: Hon. Dennis R. Dow
U.S. Bankruptcy Court (W.D. Mo.); Kansas City

Con: Hon. Marvin Isgur
U.S. Bankruptcy Court (S.D. Tex.); Houston

Resolved: A trademark licensee retains the right to use a debtor's trademark post-rejection.

Pro: Craig Goldblatt
WilmerHale; Washington, D.C.

Con: Michael L. Bernstein
Arnold & Porter Kaye Scholer LLP; Washington, D.C.

First Circuit follows the Fourth Circuit's Lubrizol and rejects the Seventh Circuit's Sunbeam.

Circuit Split Deepens on Rejection of Trademark Licenses

Pointedly disagreeing with the Seventh Circuit, the First Circuit deepened an existing split by adopting the Fourth Circuit's conclusion in *Lubrizol* and holding that rejection of a trademark license agreement precludes the licensee from continuing to use the license.

The 2/1 opinion from the First Circuit on Jan. 12 reversed the Bankruptcy Appellate Panel, which, to the contrary, had followed Circuit Judge Frank Easterbrook's decision in *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012). In *Sunbeam,* the Seventh Circuit rejected the Fourth Circuit's rationale in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

In simple terms, the First Circuit's decision means that the licensee of patents can continue using the technology after rejection as a consequence of Section 363(n), but the same licensee cannot continue using trademark licenses that went along with the technology.

The Genesis of Section 365(n)

In *Lubrizol*, the Fourth Circuit ruled in 1985 that rejection of an executory contract licensing intellectual property halted the non-bankrupt's right to use patents, trademarks and copyrights. Three years later, Congress responded by adding Section 365(n), which, in conjunction with the definition of "intellectual property" in Section 101(35A), provides that the non-debtor can elect to continue using patents, copyrights and trade secrets despite rejection of a license.

The amendment conspicuously omitted reference to trademarks. The Senate Report said that the amendment did not deal with trademarks because the issue "could not be addressed without more extensive study." According to the report, Congress decided to postpone action "to allow the development of equitable treatment of this situation by bankruptcy courts."

Since then, courts have split into two camps. One group takes a negative inference from the omission of trademarks from Section 365(n) by holding that rejection terminates the right to use a trademark, although the licensee could elect to continue using patents covered by the same agreement.

ROCHELLE'S DAILY WIRE

In *Sunbeam*, the Seventh Circuit split with the Fourth in 2012. Judge Easterbrook acknowledged that Section 365(n) does not preserve the right to use trademarks, but at the same time does not prescribe the consequences of rejection. Judge Easterbrook instead relied on Section 365(g), which teaches that rejection "constitutes a breach" of contract.

Judge Easterbrook reasoned that a licensor's breach outside of bankruptcy would not preclude the licensee from continuing to use a trademark. He ruled that rejection converted the debtor's unfulfilled obligations into damages. He said that "nothing about this process implies than any other rights of the other contracting party have been vaporized." He added that *Lubrizol* has been "uniformly criticized" by scholars and commentators.

The First Circuit Case

Before bankruptcy, the debtor in the case before the First Circuit had granted the licensee a non-exclusive, irrevocable, fully paid, transferrable license to its intellectual property including patents. However, the irrevocable license excluded the debtor's trademarks.

Separately, the license agreement granted a non-exclusive, non-transferable, limited license to use the debtor's trademarks.

The day after filing a chapter 11 petition, the debtor filed a motion to reject the trademark and patent licenses as executory contracts under Section 365(a). During the ensuing litigation, the debtor conceded that Section 365(n) allowed the licensee to retain its rights in the intellectual property and patents, but not the trademarks.

Ultimately, the bankruptcy court ruled that Section 365(n) did not preserve the licensee's rights in the trademarks. The bankruptcy judge believed that the omission of trademarks from the definition of intellectual property in Section 101(35A) meant that Section 365(n) does not protect rights in trademarks.

On the first appeal, the BAP followed *Sunbeam* and reversed the bankruptcy court, calling *Lubrizol* "draconian" and saying that rejection does not "vaporize" trademark rights. To read ABI's report on the BAP opinion, click here.

With regard to trademarks, Circuit Judge William J. Kayatta, Jr. reversed the BAP in a 2/1 opinion, holding that the right to use trademarks did not survive rejection.

Judge Kayatta said that *Sunbeam* "largely rests on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark." That premise, he said, is wrong because "effective licensing of a trademark" requires the licensor to continue monitoring and exercising control over the quality of the goods sold under the mark.

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Sunbeam is wrong, in Judge Kayatta's view, because it "entirely ignores the residual enforcement burden it would impose on the debtor just as the Code otherwise allows the debtor to free itself from executory burdens" and "invites further degradation of the debtor's fresh start options."

Judge Kayatta therefore favored "the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise."

The Dissent

Circuit Judge Juan R. Torruella dissented with regard to trademarks. Like *Sunbeam*, he would have held that rights in a trademark "did not vaporize" as a result of rejection.

Judge Torruella based his dissent in large part on the legislative history surrounding the adoption of Sections 363(n) and 101(35A). He saw Congress as allowing courts to use their equitable powers to protect trademark licensees.

Rather than eviscerating the licensee's trademark rights, Judge Torruella said he instead would "be guided by the terms of the [license agreement], and non-bankruptcy law, to determine the appropriate equitable remedy of the functional breach of contract."

Distribution Rights

The litigation in bankruptcy court also involved the debtor's license of distribution rights. Affirmed by the BAP, the bankruptcy court had ruled that rejection cut off distribution rights too.

On appeal in the circuit, the licensee mounted several creative arguments aimed at showing that distribution rights were an adjunct to the patents and technology and therefore should survive.

Judges Kayatta and Torruella agreed that rejection cut off distribution rights.

The Next Steps

If the licensee does not throw in the towel, the next step will be a petition for rehearing *en banc* or a petition for *certiorari*. The circuit split pits not only the First Circuit against the Seventh. In his concurrence in *In re Exide Technologies*, 607 F.3d 957, 964 (3d Cir. 2010), Third Circuit Judge Thomas L. Ambro reached the same result as the Seventh Circuit on much the same reasoning.

The opinion is *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 16-9016 (1st Cir. Jan. 12, 2018).

ROCHELLE'S DAILY WIRE

Boston BAP sides with Seventh Circuit, holding that trademark licenses survive rejection.

First Circuit BAP Rejects *Lubrizol* on Rejection of Trademark Licenses

The First Circuit Bankruptcy Appellate Panel aligned itself with the Seventh Circuit by holding that rejection of a trademark license does not strip the licensee of the right to use the mark, contrary to the controversial 1985 holding by the Fourth Circuit in *Lubrizol Enterprises v. Richmond Metal Finishers Inc.*

The BAP's Nov. 18 opinion by Bankruptcy Judge Melvin S. Hoffman adopted the reasoning employed by Seventh Circuit Judge Frank Easterbrook, who said in *Sunbeam Products Inc. v. Chicago American Manufacturing LLC* in 2012 that nothing in Section 365 forces the non-bankrupt party to stop using trademarks when the license is rejected.

The controversy has persisted because Congress has been flummoxed by *Lubrizol* when it comes to trademarks.

In *Lubrizol*, the Fourth Circuit ruled that rejection of an executory contract licensing intellectual property halted the non-bankrupt's right to use patents, trademarks and copyrights. Three years later, Congress responded by adding Section 365(n), which, in conjunction with the definition of "intellectual property" in Section 101(35A), provides that the non-debtor can elect to continue using patents, copyrights and trade secrets despite rejection of a license.

The amendment conspicuously omitted reference to trademarks. The Senate Report said that the amendment did not deal with trademarks because the issue "could not be addressed without more extensive study." According to the report, Congress decided to postpone action "to allow the development of equitable treatment of this situation by bankruptcy courts."

Since then, courts split into two camps. One group takes a negative inference from the omission of trademarks from Section 365(n) by holding that rejection terminates the right to use a trademark, although the licensee could elect to continue using patents covered by the same agreement.

The opposing camp is exemplified by the Seventh Circuit, where the appeals court acknowledged that Section 365(n) does not preserve the right to use trademarks, but at the same time does not prescribe the consequences of rejection. Instead, Circuit Judge Easterbrook relied on Section 365(g), which teaches that rejection "constitutes a breach" of contract.

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Judge Easterbrook reasoned that a licensor's breach outside of bankruptcy would not preclude the licensee from continuing to use a trademark. He ruled that rejection converted the debtor's unfulfilled obligations into damages. He said that "nothing about this process implies than any other rights of the other contracting party have been vaporized." He added that *Lubrizol* has been "uniformly criticized" by scholars and commentators.

Adopting the approach in *Sunbeam* and reversing the bankruptcy court, Judge Hoffman called *Lubrizol* "draconian" and said that rejection does not "vaporize" trademark rights. He also noted that *Lubrizol* is not binding on courts in the First Circuit and mentioned that the bankruptcy court had not cited *Sunbeam* in ruling that the licensee could not use trademarks after rejection.

Judge Hoffman's decision upheld the bankruptcy court's ruling that the license agreement did not confer distribution rights that would survive rejection. Intellectual property lawyers should consult the decision for hints about how to draft licenses so that distribution rights might survive rejection.

The opinion is *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 15-065 (B.A.P. 1st Cir. Nov. 18, 2016).

What did Congress mean in Sections 365(n) and 101(35A)? Is the right to use a trademark terminated when a trademark license is rejected?

'*Cert*' Petition Asks Supreme Court to Overrule *Lubrizol* on Trademark Licenses

Does the rejection of a trademark license mean that the licensee must stop using the trademark?

The circuits are split, but the Supreme Court is being given an opportunity to resolve the question and decide whether the Fourth Circuit was right or wrong in 1985 when it handed down one of most controversial bankruptcy decision of all time, *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

The licensee of a rejected trademark license filed a petition for *certiorari* in the Supreme Court from the First Circuit's opinion in January in *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 879 F.3d 389 (1st Cir. Jan. 12, 2018). The petition is likely to be considered by the justices at their so-called long conference in late September. We may know as early as September 27 whether the high court will hear the case in the term to begin in October. If *certiorari* is granted, oral argument could take place in December 2018.

The Circuit Split

In *Lubrizol*, the Fourth Circuit held in 1985 that rejecting an executory contract for intellectual property bars the non-bankrupt from continuing to use patents, trademarks and copyrights. Congress responded three years later by adding Section 365(n) and the definition of "intellectual property" in Section 101(35A). Together, they provide that the non-debtor can elect to continue using patents, copyrights and trade secrets despite rejection of a license.

The amendment omitted reference to trademarks. The Senate Report said that the amendment did not mention trademarks because the issue "could not be addressed without more extensive study." In the meantime, Congress said it would "allow the development of equitable treatment of this situation by bankruptcy courts."

As a result of the omission of trademarks from the definition of "intellectual property," the lower courts were split when it comes to deciding whether rejection of a trademark license precludes the licensee from continuing to use the mark. Some courts interpreted Sections 365(n)

and 101(35A) as implying a legislative adoption of *Lubrizol* when it comes to trademarks. Other lower courts disagreed.

The Seventh Circuit was the first court of appeals to weigh in when it handed down *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012). The Chicago-based court disagreed with *Lubrizol* and held that "nothing about this process [of rejection] implies that any other rights of the other contracting party have been vaporized." Holding that the right to use the trademark was not terminated by rejection, Circuit Judge Frank Easterbrook noted how *Lubrizol* has been "uniformly criticized" by scholars and commentators.

The split crystalized at the circuit level when the First Circuit handed down *Tempnology* in January. The majority in the 2/1 decision sided with *Lubrizol* and criticized *Sunbeam* for "largely [resting] on the unstated premise that it is possible to free a debtor from any continuing performance obligations under a trademark license even while preserving the licensee's right to use the trademark." The majority favored "the categorical approach of leaving trademark licenses unprotected from court-approved rejection, unless and until Congress should decide otherwise."

The licensee filed a petition for *certiorari* on June 11. Counsel for the petitioner-licensee includes Danielle Spinelli, a former Supreme Court clerk who argued on the winning side in two recent bankruptcy cases, *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), and *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

The *Tempnology* '*Cert*' Petition

The licensee in *Tempnology* tells the justices in the *certiorari* petition that the First Circuit worsened an existing circuit split on an "openly acknowledged, and longstanding division of authority among the courts of appeals." The petitioner says that the split "is entrenched and will not resolve itself without this Court's intervention."

Arguing that the First Circuit was wrong, the petitioner adopts the approach in *Sunbeam* by contending that rejection of an "executory contract is merely a breach," as provided in Section 365(g). The Boston-based appeals court, it says, confused the power of rejection with the avoidance power.

In addition to *Sunbeam*, the petitioner finds support at the circuit level in the concurring opinion by Third Circuit Judge Thomas L. Ambro in *In re Exide Technologies*, 607 F.3d 957, 964 (3d Cir. 2010). Judge Ambro advocated the same result as the Seventh Circuit on much the same reasoning.

The *Tempnology* petition seeks high court review of a second question: Can the exclusive right to sell a product be terminated by rejection of an executory contract? In other words, is "exclusivity" an intellectual property right that is treated the same for rejection purposes as a trademark and other intellectual property?

Although the petitioner cites scholars in support of its argument that the First Circuit was wrong, there may be no circuit split. Absent a circuit split on exclusivity, the Supreme Court might grant *certiorari* but limit review to the *Lubrizol* issue.

The *certiorari* petition is *Mission Product Holdings Inc. v. Tempnology LLC*, 17-1657 (Sup. Ct.).

A 'cert' petition is in the works to resolve the circuit split from Lubrizol regarding the rejection of trademark licenses.

Connecticut Judge Takes Sides in a Circuit Split on Trademark License Rejection

A case from the bankruptcy court in Connecticut may allow the Second Circuit to take sides in a circuit split on the question of whether rejection of an executory contract bars the licensee from continuing to use a trademark license.

However, the Supreme Court may resolve the split before the issue ever reaches the Second Circuit if the justices grant *certiorari* to review this year's First Circuit decision in *Mission Product Holdings Inc. v. Tempnology LLC (In re Tempnology LLC)*, 879 F.3d 389 (1st Cir. Jan. 12, 2018). A final appeal in *Tempnology* would enable the high court to expound on the effects of rejecting executory contracts while either upholding or rejecting the Fourth Circuit's controversial opinion in *Lubrizol Enterprises Inc. v. Richmond Metal Finishers Inc.*, 756 F.2d 1043 (4th Cir. 1985).

The Connecticut Case

Bankruptcy Judge James J. Trancredi confronted a typical intellectual property dispute with a few twists. Basically, the chapter 7 debtor owned and licensed software and accompanying trademarks. The trustee filed a motion to reject a software and trademark license agreement where the licensee had ambiguous exclusivity rights in the technology.

The trustee argued that the technology would fetch a considerably higher price at a later bankruptcy sale if rejection would preclude the licensee from using the technology and trademarks.

The licensee effectively conceded the trustee's right to reject the contract but elected under Section 365(n) to continue using the "intellectual property," as that term is defined in Section 101(35A).

In his May 17 opinion, Judge Tancredi aligned himself with the Seventh Circuit in the circuit split by holding that rejection did not "abrogate" the licensee's right to use the trademarks or to enforce its exclusivity rights.

The Circuit Split

Judge Tancredi traced the tortured history in case law dealing with the rejection of executory contracts licensing intellectual property.

In *Lubrizol*, the Fourth Circuit held in 1985 that rejecting an executory contract for intellectual property barred the non-bankrupt from continuing to use patents, trademarks and copyrights. Congress responded three years later by adding Section 365(n), which, together with the definition of "intellectual property" in Section 101(35A), provides that the non-debtor can elect to continue using patents, copyrights and trade secrets despite rejection of a license.

The amendment omitted reference to trademarks. The Senate Report said that the amendment did not mention trademarks because the issue "could not be addressed without more extensive study." In the meantime, Congress said it would "allow the development of equitable treatment of this situation by bankruptcy courts."

Later, courts went in two directions. One camp takes a negative inference from the omission of trademarks from Section 365(n) and holds that rejection terminates the right to use a trademark, even though the licensee could elect to continue using patents covered by the same agreement.

In *Sunbeam Products Inc. v. Chicago American Manufacturing LLC*, 686 F.3d 372 (7th Cir. 2012), the Seventh Circuit split with the Fourth in 2012 when Judge Frank Easterbrook held that rejection "constitutes a breach" of contract under Section 365(g). Outside of bankruptcy, he said, a licensor's breach would not preclude the licensee from continuing to use a trademark. He held that "nothing about this process [of rejection] implies that any other rights of the other contracting party have been vaporized." Holding that the right to use the trademark was not terminated by rejection, he noted how *Lubrizol* has been "uniformly criticized" by scholars and commentators.

In his concurrence in *In re Exide Technologies*, 607 F.3d 957, 964 (3d Cir. 2010), Third Circuit Judge Thomas L. Ambro reached the same result as the Seventh Circuit on much the same reasoning.

Sunbeam and *Exide* did not turn the tide, because the First Circuit resurrected *Lubrizol* early this year in *Tempnology*, when the majority on a panel from the Boston-based appeals court held that rejection of a trademark license agreement precludes the licensee from continuing to use the mark.

In *Tempnology*, the losing side sought and obtained an extension of time to file a petition for *certiorari* in the Supreme Court. The deadline to file the petition is June 11. Evidently serious about going up, the petitioner has retained Danielle Spinelli, a former Supreme Court clerk who argued on the winning side in two recent bankruptcy cases: *Czyzewski v. Jevic Holding Corp*., 137 S. Ct. 973 (2017), and *Clark v. Rameker*, 134 S. Ct. 2242 (2014).

Judge Tancredi Sides with the Seventh and Third Circuits

Judge Tancredi said that *Tempnology* "is plainly contrary to Congress' explicit efforts to rebalance affected rights on intellectual property and leave Section 365(g) to answer otherwise unresolved trademark issues." Judge Tancredi said he would align himself with the Seventh Circuit and the "plain reading of Section 365(g)." Quoting a bankruptcy judge in New York, he said that rejection "'does not make the contract disappear.'"

Under Connecticut law, Judge Tancredi said that rejection of the license would not be a material breach because taking the election under Section 365(n) preserved the licensee's intellectual property and exclusivity. Therefore, he said, "the core of the bargain and substantial purpose of the License Agreement has been preserved."

Judge Tancredi held that the licensee's election under Section 365(n) preserved its exclusive rights to use the technology. He also held that "all royalty and payment provisions . . . remain in full force and effect."

Given the stark disagreement among the circuits on a controlling issue of law, the trustee in Judge Tancredi's case might request a direct appeal to the Second Circuit. However, the Supreme Court may resolve the split before the Second Circuit takes sides.

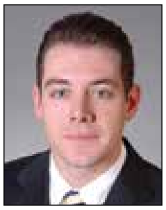
To read ABI's discussion about *Tempnology*, click here.

The opinion is *In re SIMA International Inc.*, 17-21761 (Bankr. D. Conn. May 17, 2018).

Lien on Me

By Oscar N. Pinkas and Lauren Macksoud[1]

Second Circuit Sets Interest Rate Standard and Denies Make-Whole in *Momentive* Cramdown Plan



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On Oct. 20, 2017, the Second Circuit Court of Appeals issued its decision in *Momentive Performance Materials Inc. v. BOKF NA*[2] and rendered two critical holdings. First, senior secured creditors that are issued replacement notes under a plan should not be forced to accept interest at the "formula" rate (*i.e.*, a rate set by using the risk-free rate plus a plan-specific risk adjustment) in the first instance.[3] Instead, the Second Circuit held that where an "efficient market" exists, the market should dictate the interest rate, with the formula rate being applicable only if no such market exists.

The Second Circuit remanded the issue to the bankruptcy court with instructions to determine whether an efficient market rate exists, and if so, to apply that rate to the notes. In so holding, the Second Circuit issued a victory to secured creditors by reducing the likelihood that they will be forced to accept takeback paper with below-market rates of interest in the context of a cramdown.

Second, the court determined that no make-whole was payable because the automatic acceleration of the notes (the "senior-lien notes" and the holders, the "noteholders") on the petition date of the bankruptcy precluded an optional redemption, determining specifically that the automatic stay precluded the noteholders from unwinding the acceleration in an attempt to enhance their recovery. The Second Circuit followed its prior precedent, but its decision appears to conflict directly with controlling case law in the Third Circuit, which might lead to forum-shopping.

The Plan

Momentive Performance Materials Inc. (MPM) and its affiliated debtors (collectively, the "debtors") commenced a prearranged bankruptcy case in 2014 amidst a dispute with the noteholders over an entitlement to a make-whole premium.[4] In order to resolve the dispute and entice the noteholders to vote in favor of their chapter 11 plan, the debtors gave the noteholders two options:[5] They could either accept the plan and receive an immediate payment of cash in full (while otherwise waiving any make-whole claim they might have), or reject the plan, preserve their make-whole argument and receive takeback paper priced at the formula rate set by the U.S. Supreme Court's decision in *Till v. SCS Credit Corp*.[6]

The noteholders rejected the plan and filed confirmation objections alleging that the plan was not fair and equitable, as required by § 1129(b) of the Bankruptcy Code.[7] The noteholders argued that they were entitled to their make-whole premiums and further argued that the takeback paper carried an interest rate that was well below the going market rate as compared to similar outstanding debt obligations.[8] Nonetheless, the bankruptcy court confirmed MPM's plan over the noteholders' objections, finding that the indentures did not require the payment of a make-whole premium and that the below-market interest rates were enough to satisfy the Code's cramdown provisions of § 1129.[9] On appeal, the district court affirmed the bankruptcy court's findings.[10]

The Second Circuit Opinion

The noteholders then appealed to the Second Circuit.[11] In its long-awaited decision, the Second Circuit found that the noteholders' expert testimony in the bankruptcy court would, if credited, have established a market rate.[12] Since "an efficient market [might] exist that generates an interest rate that is apparently acceptable to sophisticated parties dealing at arm's-length," the Second Circuit con-

1 Nothing in this article constitutes an opinion or view of the authors, Dentons US LLP or any of their clients.
2 When this article was written, the petition for rehearing at the Second Circuit was pending, so the outcome of any further litigation beyond the Second Circuit decision is not accounted for.
3 *See Momentive Performance Materials Inc. v. BOKF NA (In the Matter of MPM Silicones LLC)*, 2017 WL 4700314, No. 15-1682 (2d Cir. Oct. 20, 2017).
4 At the time of the filing, the debtors had four classes of bond debt outstanding, including subordinated unsecured notes (the "subordinated notes"), second-lien notes, and first-lien and 1.5-lien notes (together, the "senior-lien notes").

5 *MPM Silicones*, 2017 WL 4772248 at 2.
6 *Id.*
7 *Id.*
8 *Id.*
9 *Id.* at 3.
10 *Id.*
11 The subordinated noteholders, who received nothing under the plan, also filed an appeal contending that under the relevant indenture provisions, their subordinated notes were not subordinate to the second-lien noteholders and, consequently, they were entitled to some recovery. The bankruptcy court rejected this argument, and the Second Circuit upheld this decision on appeal. However, the decision required an analysis of ambiguities in the indenture to ascertain the parties' intentions, so an expected outcome of the *MPM* decision is also more explicit delineation of priorities (payment, lien and enforcement) in debt documents to avoid those disputes going forward.
12 *MPM Silicones*, 2017 WL 4772248 at 9.

cluded that "such a rate is preferable to a formula improvised by a court."[13] In so finding, the Second Circuit considered whether the takeback paper described in the plan would satisfy the cramdown standard of § 1129(b),[14] which requires that a plan be fair and equitable and not discriminate unfairly with respect to impaired classes of claims who have not voted to accept the plan.

Section 1129(b)(2)(A)(II) allows a plan to distribute to a class of secured creditors "deferred cash payments totaling at least 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." In other words, while a debtor may force a secured creditor to accept deferred payment on its claim (*i.e.*, the "cramdown"), the payments must ultimately amount to the full value of the secured creditor's claim.

The Second Circuit found that the lower courts erred in relying on the Supreme Court's endorsement of the "formula" approach outlined in *Till*.[15] The *Till* decision involved the calculation of a cramdown interest rate on replacement notes issued to the secured creditor of a chapter 13 debtor's subprime auto loan. As with chapter 11, chapter 13 allows debtors to provide secured creditors with deferred cash payments, as long as the value as of the effective date of the plan is not less than the allowed amount of the claim.[16] The *Till* court was unable to achieve a majority on the interest-calculation method to be used, resulting in a plurality opinion endorsing the "formula" method.

The Second Circuit conducted a thorough review of the *Till* decision and ultimately found that *Till* did not conclusively state whether the "formula" rate was generally required in chapter 11 cases.[17] The Second Circuit pointed to the often-cited footnote 14 to support the notion that efficient market rates for cramdown loans cannot be ignored in chapter 11 cases.[18] In footnote 14, the *Till* court noted that while in chapter 13 cramdowns "there is no free market of willing cramdown lenders," the "same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession."[19] "Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."[20]

In *In re American Home Patient Inc.*, the Sixth Circuit used footnote 14 to justify its adoption of a two-part process for selecting an interest rate in a chapter 11 cramdown situation.[21] The Sixth Circuit said that "the 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."[22] The Second Circuit chose to adopt this two-step approach and remanded to the bankruptcy court the issue of whether an efficient market exists, and if so, instructed the bankruptcy court to apply that rate instead of the formula rate.

The Second Circuit next considered whether the noteholders were entitled to a make-whole premium. The noteholders argued that they were entitled to the premium because, in issuing replacement notes under the plan, the debtor "redeemed" the notes "at its option" prior to maturity.[23] The Second Circuit disagreed.

In relying on its decision in *In re AMR Corp.*,[24] the Second Circuit said that "acceleration brought about by a bankruptcy filing changes the date of maturity of the accelerated notes to the date of the petition."[25] Accordingly, "any payment on the accelerated notes following a bankruptcy filing would be a post-petition maturity date."[26] Since the [note]holders conceded that the meaning of the term "redeem" is to "repay ... a debt security ... at or before maturity," then clearly there was no redemption.[27]

Further, the Second Circuit found that even if MPM did redeem the notes, the redemption was not optional. The court found that the "obligation to issue the replacement notes came about automatically by operation of ... the indentures' Automatic Acceleration Clauses."[28] Under the indentures at issue, the filing of a voluntary bankruptcy petition constituted a default that led to an automatic acceleration. Accordingly, the Second Circuit found that "a payment made mandatory by operation of an automatic acceleration clause is not one made at MPM's option."[29]

Lastly, the noteholders argued that the lower courts erred in disregarding their contractual rights to rescind acceleration, which would otherwise have the effect of reinstating the original maturity.[30] Again relying on its decision in *AMR*, the Second Circuit disagreed, finding that a creditor's post-petition invocation of a contractual right to rescind an acceleration triggered automatically by a bankruptcy filing in order to recover a make-whole premium is barred as an attempt to modify a contract in violation of the automatic stay.[31]

EFIH Distinguished

This portion of the *MPM* decision puts the Second Circuit at odds with the Third Circuit on how make-whole premiums are viewed. In *In re Energy Future Holdings Corp.* (*EFIH*), the Third Circuit addressed similarly worded indentures also governed by New York law and found that the noteholders there were entitled to payment of an optional redemption premium at the make-whole price as a result of the repayment of their notes in the bankruptcy.[32] As with *MPM*, the *EFIH* court also looked at the issues of whether there was a redemption, and if so, whether that redemption was optional. The Third Circuit first found that a redemption may occur either before or after an automatic acceleration

13 *Id.* at 10.
14 *Id.* at 7.
15 541 U.S. 465 (2004).
16 11 U.S.C. § 1325(a)(5)(B)(ii).
17 *MPM Silicones*, 2017 WL 4772248 at 7-8.
18 *Id.*
19 541 U.S. at 476 n.14, 124 S. Ct. 1951.
20 *Id.*
21 420 F.3d 559, 568 (6th Cir. 2005).
22 *Id.*
23 *MPM Silicones*, 2017 WL 4772248 at 11.
24 730 F.3d 88 (2d Cir. 2013).
25 *MPM Silicones*, 2017 WL 4772248 at 11.
26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.*
30 *Id.* at 12.
31 *Id.*
32 842 F.3d 247 (3d Cir. 2016).

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that is triggered by a voluntary bankruptcy filing.[33] Despite the fact that the notes were automatically accelerated when EFIH filed for bankruptcy, the indentures at issue did not cancel EFIH's obligations to pay the redemption premiums in the event of an acceleration.[34]

In deciding whether the redemptions were optional, the Third Circuit found that once in bankruptcy, EFIH had the option to either reinstate the accelerated notes' original maturity date under § 1124(2) of the Bankruptcy Code or refinance.[35] The court said that "a chapter 11 debtor that has the capacity to refinance secured debt on better terms ... is in the same position within bankruptcy as it would be outside [of] bankruptcy, and cannot reasonably assert that its repayment of debt is not voluntary."[36] This is where the Second and Third Circuit cases differ factually.

It should be noted that *EFIH* dealt with a solvent debtor that refinanced its debt in bankruptcy and, once approved, paid off its existing notes at a much lower interest rate without paying the pre-petition secured lenders' make-whole premiums. On the other hand, *MPM* involved a debtor issuing takeback paper pursuant to a plan. This could be an important distinction, especially in an effort to try to reconcile the holdings in the two cases, particularly on the issue of the optional redemption. It would be interesting to see whether the Third Circuit would have come to a different conclusion on the make-whole issue if presented with facts similar to those in *MPM*.

33 *Id.* at 255.
34 *Id.*
35 *Id.*
36 *Id.*

Conclusion

The Second Circuit's decision in *MPM* is good news for secured creditors in that it should help to eliminate the threat of debtors forcing them to accept below-market takeback paper in bankruptcy. However, it remains to be seen whether the bankruptcy court, on remand, will find that an efficient market did exist. Therefore, it might be a fertile battleground going forward to define the perimeters of an efficient market in different contexts in order to sway the interest rate payable. While a test has now been adopted by the Second Circuit, the prospect of fact-intensive and expensive litigations between the debtors and secured creditors remains on whether an efficient market exists and, if so, what the efficient market rate should be.

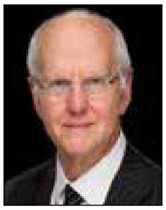
In addition, the Second and Third Circuit split on the make-whole issue could give rise to forum-shopping by debtors looking to get out from underneath significant make-whole obligations. Either way, the *MPM* and *EFIH* decisions caution both issuers and creditors to carefully draft make-whole provisions regarding whether make-whole premiums are to be owed to creditors after a company's bankruptcy filing. abi

Feature

By David R. Kuney[1]

The Myth of the "Efficient Market"

Restructuring Real Estate Mortgages



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In the past few years, the number of single-asset real estate bankruptcy cases has declined. The widespread use of "springing guaranties," which impose guaranty liability on the ultimate owners if the borrowing entity decides to file for bankruptcy, have been one factor. Another factor might have been low interest rates and the willingness of lenders to restructure mortgage debt. However, this may soon change.

With the continuing rise of retail bankruptcies, the related loss of rental income and the anticipated increase in the national interest rate, the need for bankruptcy relief in the commercial real estate sector might increase. If so, it will be important to understand how recent legal developments may alter the ability to file such cases and to confirm a reorganization plan.

First, a bankruptcy court recently held that a lender could not utilize a "special director" whose sole responsibility was to vote "no" on any borrower resolution to seek bankruptcy protection.[2] Second, the recent U.S. Supreme Court case of *Czyzewski v. Jevic*[3] could tempt some to argue that the "new value corollary," which permits the cramdown of the unsecured deficiency part of a mortgage, might be an impermissible form of class-skipping.[4] A third possible change addresses the required interest rate on the restructured "cramdown" loan.

Real estate restructuring may well rise or fall on a court's determination of whether a restructured real estate loan will incur an interest obligation under the Supreme Court's notion of a "formula" rate as set forth in *Till v. SCS Credit Corp.*[5] A new decision from the Second Circuit, *Momentive Performance Materials Inc. v. BOKF NA (In the Matter of MPM Silicones LLC)*, might significantly alter how courts set interest rates on mortgage loans.[6]

The Pricing Issue

One of the most important issues of bankruptcy law for real estate lenders and borrowers is this question: What is the appropriate rate of interest that must be paid when a mortgage borrower proposes a reorganization plan that restructures its mortgage debt? A change in only a percentage or two on a multi-million-dollar commercial loan can mean the difference between a plan being "feasible" or not. A higher interest rate will doom the prospects for confirmation if the cash flow from the commercial project is not sufficient enough to service the debt requirement.

The Bankruptcy Code provides that when a borrower proposes to restructure a secured loan, the terms of the new debt instrument must ensure that the lender will receive deferred cash payments, over time, that have a "value," as of the effective date of the reorganization plan, at least equal to the value of the lender's collateral for the mortgage. Simply stated, the restructured bankruptcy loan will have the principal balance of the loan reduced to the market value of the collateral, and the balance (if any) becomes an unsecured deficiency claim. The rate of interest on the secured portion must provide that the income stream has a present value equal to the value of the collateral. This is part of the essence of "cramdown."

In 2004, the Supreme Court held in *Till* that in determining the correct interest rate, courts should generally use a "formula" approach and not necessarily apply a rate determined by comparable loans in the marketplace. This approach begins with a "risk-free" interest rate, specifically, the "national prime rate ... which reflects the financial market's estimate of the amount [that] a commercial bank should charge a creditworthy borrower to compensate for the opportunity costs of the loan, the risk of inflation, and the relatively slight risk of default."[7]

The Court then suggested that the risk adjustment observed in many cases seemed to be 1-3 percentage points above the national prime rate of interest.[8] This latter "adjustment" of 1-3 percentage points was not *required* by law, but was merely an observation by the Court. Nonetheless, it became commonplace to think of *Till* as holding that the applicable cramdown rate was "prime plus one to three." The Supreme Court cautioned against "eye-popping" rates that were often sought

1 The views expressed herein are those of the author and not of the lawyers or the firm of Whiteford Taylor Preston LLP.
2 *In re Intervention Energy Holdings LLC*, 553 B.R. 258, 263 (Bankr. D. Del. 2016) ("The Debtors note in their Response that it is axiomatic that a debtor may not contract away the right to a discharge in bankruptcy.").
3 137 S. Ct. 973 (2017).
4 The opening pages in the brief for the petitioner in *Jevic* stated that "the single most important principle of Chapter 11 is the rule of absolute priority." (Petition for *certiorari*, p. 3.) Because I questioned this fundamental assertion, I authored (along with two other prominent law professors) an *amicus* brief that cautioned against an over-exuberant expansion of the absolute priority rule. *See* Brief for *Amici Curiae* Law Professors in Support of Respondents, Case No. 15-649.
5 541 U.S. 465 (2004) ("*Till*").
6 874 F.3d 787 (2d Cir. 2017) ("*MPM*").
7 541 U.S. at 479.
8 "We do not decide the proper scale for the risk adjustment, as the issue is not before us. The Bankruptcy Court in this case approved a risk adjustment of 1.5%, App. to Pet. for Cert. 44a-73a, and other courts have generally approved adjustments of 1% to 3%." *Id.*, 541 U.S. at 480.

by lenders as a way to make a proposed plan unfeasible, and hence, not confirmable.

Till arose in the context of a chapter 13 consumer bankruptcy case, and there was some uncertainty about whether *Till* applies to chapter 11. Justice John Paul Stevens stated that the same principles pertain in all chapters,[9] yet *Till* contained infamous footnote 14, which stated that in chapter 11, there might be an efficient market, and if so, a court could consider using the efficient market rate: "Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."

The Supreme Court consciously declined to adopt the existing market-rate approach that some courts had used under the heading of the "coerced loan" model, which asks how a similar loan would be priced in that region for a new loan with similar terms. Among other concerns, the Court felt that a consideration of the marketplace for comparable loans was an "inquiry far removed from such courts' usual tasks ... and overcompensates" the lender.[10] In addition, "Under the plurality opinion in *Till*, the value of the obligation, naturally dependent on the interest it bears, is not determined by the market."[11]

American HomePatient: The Post-*Till* Debate over Footnote 14

Shortly after *Till*, there was something of a firestorm of cases and articles on whether *Till* should apply in a commercial chapter 11 case. Part of the problem was — and remains — the nebulous notion of what is an "efficient market" for cramdown loans. There seemed to be a continual tension between the core ruling by Justice Stevens that the same principles of "present value" should apply in all Code chapters, and the somewhat unclear reference in footnote 14.

Bank of Montreal v. Off. Comm. Of Unsecured Creditors (In re American HomePatient Inc.)[12] was an early effort to determine what role *Till* would serve in a commercial chapter 11 case. The Sixth Circuit held that one example of an efficient market was where the markets offer "a loan with a term, size and collateral comparable to the forced loan contemplated under the cramdown plan."[13] The Sixth Circuit held that *Till* required a two-step process: A court should ascertain whether there is an efficient market, and if not, then the court should employ the "formula approach."

The bankruptcy court's decision in *American HomePatient* was decided before *Till*, and the law in the Sixth Circuit had the coerced loan method. The bankruptcy court used the "rubric" of this model, which had been rejected by the Supreme Court.[14] Nevertheless, the Sixth Circuit believed that the bankruptcy court had, in essence, sought to determine what an efficient market would charge. The "efficient market" seems to be one that priced the loan as "senior debt ... in the health care field under a normalized capital structure."[15]

9 *Id.* at 474 and n.10, 124 S. Ct. 1951.
10 *Id.* at 477.
11 *In re Mirant* at 821. *See* David R. Kuney, *The Single Asset Real Estate Case* (ABI 2012), pp. 138, *et seq. But cf. In re Prussia Assocs.*, 322 B.R. 572 (Bankr. E.D. Pa. 2005), noting that an efficient market might exist for real estate cramdown loans in certain circumstances.
12 420 F.3d 559 (6th Cir. 2005).
13 *Id.* at 568.
14 *Id.*
15 *Id.*

It is unclear whether *American HomePatient* somewhat conflated the notion of a market rate with an efficient market. The Supreme Court seemed determined not to use a market rate and rejected the coerced loan model. The lower court in *American HomePatient* may have done exactly what the Supreme Court said not to do. To some extent, the debate over interest rates in the commercial real estate context faded because of the relatively few number of chapter 11 real estate cases. This may now change in the coming 12-24 months.

MPM and the Revival of *Till* and *American HomePatient*

MPM is almost certain to renew this debate over loan pricing, both in real estate cases and elsewhere. MPM was a leading manufacturer of silicone. As part of its reorganization plan, it ultimately sought to invoke *Till* and use the formula approach of the national prime rate plus a modest risk adjustment. Initially there were two classes of senior secured notes, which, before the bankruptcy filing, had contractual interest rates of 8.875 and 10 percent.[16]

As part of the reorganization plan, the debtors proposed to pay interest on the restructured notes of 4.1 and 4.85 percent — rates that the bankruptcy court acknowledged were "below market in comparison with rates associated with comparable debt obligations."[17] The bankruptcy court applied risk adjustments of 2 and 2.75 percent, which it added to the Treasury rate of 2.1 percent, to arrive at interest rates of 4.1 and 4.85 percent, respectively.[18]

Hon. **Robert D. Drain**, writing for the bankruptcy court, confirmed the proposed reorganization plan and held that the bankruptcy courts should not use a "market rate" but should use the formula approach. In *In re MPM Silicones LLC*,[19] Judge Drain left no ambiguity that he applied the "formula" approach, as dictated by the *Till* plurality, and in so doing "explicitly declined to consider market forces."[20] Further, Judge Drain questioned the validity of the two-step approach in *American HomePatient* and concluded that the existence of an efficient market was doubtful. Indeed, there were two fatal defects with using footnote 14 as a basis for extracting binding precedent.

First, footnote 14 reflected a fundamental mistake by the Supreme Court. The footnote refers the reader to a website that deals with debtor-in-possession (DIP) financing and not "exit" financing. As Judge Drain noted, there might be many willing lenders for short-term DIP financing at the start of the case, with its typical abundance of safeguards and hyper-default provisions. However, this is not so with permanent, long-term exit financing that forces the lender to use state law remedies, and not the bankruptcy court, as its chief enforcer.

Second, the "first principles" that came from *Till* contradicted the very notion of using a market rate at all, stating "that such a two-step method, generally speaking, misinterprets *Till* and *Valenti* and the purpose of section

16 874 F.3d at 792.
17 *Id.* at 799.
18 *MPM*, 874 F.3d at 799, n.8.
19 Case No. 14-22503, 2014 WL 4436335 (Bankr. S.D.N.Y. 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015).
20 *MPM*, 874 F.3d 787 at 801, n.12.

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The Myth of the "Efficient Market": Restructuring Real Estate Mortgages

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1129(b)(2)(A)(i)(II) ... the first step of the two-step approach is almost, if not always, a dead end." Prior case law showed that courts had spent a lot of time only to determine that there was no efficient market.[21] The court continued, "This should not be surprising because it is highly unlikely that there will ever be an efficient market that does not include a profit element, fees, and costs, thereby violating *Till* and *Valenti*'s first principles, since capturing profit, fees [and] costs is the marketplace lender's reason for being."[22] Lastly, "footnote 14 should not be read in a way contrary to *Till* and *Valenti*'s first principles, which are instead of applying a market-based approach, a present value cramdown approach using an interest rate that takes the profit out."[23]

The Second Circuit disagreed and remanded with instructions to the court to determine whether there was an efficient market, stating, "We adopt the Sixth Circuit's two-step approach, which ... best aligns with the Code and relevant precedent."[24] Further, it held 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.'"[25] In short, unlike Judge Drain, it found footnote 14 to be persuasive, saying that "efficient market rates for cramdown loans cannot be ignored in Chapter 11 cases."[26] It made no conclusion as to the outcome.

MPM was remanded to the bankruptcy court to at least determine whether there was an efficient market, and if so, to apply that rate instead of the formula approach of *Till*.[27] The Second Circuit did not share Judge Drain's concerns over *American HomePatient*, stating in a footnote that "[t]he bankruptcy court should have the opportunity to engage the *American HomePatient* analysis in earnest."[28]

Assessment

Judge Drain doubted that there was ever likely going to be an efficient market for any commercial loan, since commercial lenders must build in fees, profits and costs (this being the essence of their existence). Likewise, it is questionable whether, in the real estate context of cramdown, there is likely to be an efficient market because the cramdown mortgage loan is "marked to market," meaning that the principal amount is the value of the real property. Thus, the cramdown loan has a 100 percent loan-to-value ratio. It is unlikely that such financing is available on the open market.

There are other good reasons to use the *Till* formula approach in chapter 11, although there has been substantial disagreement.[29] The risk of default following confirmation should be slight. In order to be confirmed, the proposed loan must meet the feasibility standard of § 1129(a), and in that sense, the cramdown loan might be "underwritten" more carefully than some commercial loans.

Further, the confirmation process should provide sufficient assurances that the default risk is minimized through a valuation of collateral that is required by law to be at least equal to the amount of the loan. A valuation hearing in a sophisticated bankruptcy court, with competing experts, might be equal to commercial bank loan processing.

Policy reasons also favor the use of the formula approach because it provides greater access to the bankruptcy process and more meaningful debt relief to struggling debtors, both inside and outside of real estate. Adoption of the formula approach also reduces bankruptcy litigation and the army of experts lining up to dispute the applicable market rate of interest — each insisting on different comparables and relevant factors. One of the core purposes of bankruptcy law is to rehabilitate assets and make them productive again; this might be best served by making bankruptcy more accessible, not less. The need to add risk adjustments or profit factors seems unduly restrictive and not what the Supreme Court had in mind in *Till*.

Regardless, *MPM* will put the issue of interest rates back in play. With interest rates likely to rise, this could make real estate restructurings more costly. The Third Circuit and the Delaware courts have not followed *American Home Patient*; thus, it remains to be seen whether real estate cases will be filed in Delaware with the hope of finding a more favorable pricing regime. Whether owners of commercial real estate will file for bankruptcy cases at all, however, remains problematic as long as the springing guaranty remains an obstacle. abi

Editor's Note: *The author also wrote the forthcoming ABI title* Retail and Office Bankruptcy: Landlord/Tenant Rights, *available for presale at store.abi.org*.

21 *Id.* at *28.
22 *Id.*
23 *Id.*
24 *Id.* at 800.
25 *Id.*
26 *Id.*
27 *Id.* at 801.
28 *Id.* at 801, n.12.

29 The ABI Commission to Study the Reform of Chapter 11 recommended a market-based model and rejecting the *Till* "prime plus" formula. *See ABI Commission to Study the Reform of Chapter 11 Final Report and Recommendations* at 237, *available at* commission.abi.org/full-report.