Momentive: Revisiting *Till* and Secured Creditor Cramdown

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Cramdown of Secured Creditors –§1129(b)

- A plan may be confirmed over the dissenting vote of a class of secured creditors if:
  - Fair and equitable
  - No unfair discrimination

- A plan is “fair and equitable” with respect to a class of secured creditors if:
  - The secured creditors (i) retain prepetition liens and (ii) receive deferred cash payments equal to the allowed amount of their claims;
  - The collateral is sold free and clear of the old liens, with new liens to attach to the proceeds of the sale; or
  - The secured creditors receive the “indubitable equivalent” of their claims.

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Till v. SCS Credit Corp., 541 U.S. 465 (2004)

- Chapter 13 individual debtor – sought to lower the interest rate on an auto loan with a prepetition 21% interest rate.

- Plurality
  - Adopted formula approach to cramdown interest rate – courts should begin with the risk-free rate and add a premium (1-3% for most debtors) to compensate for risk of non-payment.
  - Rejected various proposed market rate tests.
  - Footnote 14 can be read to suggest that in the chapter 11 context it may make sense to consider the rate of an efficient market:
    - "This fact helps to explain why there is no readily apparent Chapter 13 cram down market rate of interest. Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. [citations omitted]. Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure."

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Till in Chapter 11 Cases

- Following *Till*, certain courts adopted a market rate test for chapter 11 debtors, using the formula approach when there was no persuasive evidence about an efficient market.

- In *Delphi* and *A&P* Judge Drain had hinted strongly that his position would be that the *Till* formula rate applied in the chapter 11 context because a market rate would overcompensate creditors by including an element of profit.

- *In re Valenti*, 105 F.3d 55 (2d. Cir. 1997) was a chapter 13 case which, like *Till*, rejected the use of a "forced loan" approach to determine the cramdown rate, as using the rate of a new forced loan would overcompensate creditors by improperly giving creditors an element of profit. Like *Till*, *Valenti* held that the cramdown rate should be the risk-free rate plus a risk premium of 1-3%.
    - *Valenti*'s reasoning and rejection of a forced loan approach was applied in the chapter 11 context pre-*Till*. *In re Marfin Ready Mix Corp.*, 220 B.R. 148, 158 (Bankr. E.D.N.Y. 1998)
    - *Valenti* was cited favorably by *Till*

Momentive Prepetition Situation Overview

- Silicones and quartz producer with locations in the Americas, Europe and Asia.
- Strong revenue – $2.4 billion for 2013.
- Limited liquidity – $200 million at the end of 2013, less than one year of projected liquidity.
- Overlevered – $4.2 billion in total debt,16x Momentive's 2013 EBITDA; $300 million in annual interest obligations.

Momentive Capital Structure (Simplified Version)

Debt Issuance	Prepetition	Proposed Plan
First Lien Notes	$1.1 billion at 8.875%	$1.1 billion at treasury rate + 1.50% (~3.5-4.0%)
1.5 Lien Notes	$250 million at 10.00%	$250 million at treasury rate + 2.00% (~4.0-4.5%)
Second Lien Notes	$1.161 billion at 9% / €133 million at 9.5%	Exchanged for equity in Reorganized MPM and right to participate in $600m Rights Offering
Senior Subordinated Notes	$382 million at 11.5%	No distribution on account of subordination provisions

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Momentive Plan Summary

- First and 1.5 Lien Notes had make-whole provision (same language as EFH Second Lien Notes); Plan gave noteholders option to:
  - Vote for Plan and receive payment in full in cash (but no make-whole); or
  - Vote against Plan and litigate the make-whole and receive Replacement Notes

- Interest rates for the Replacement Notes were derived per the *Till* formula:
  - Replacement First Lien Notes - Treasury rate + 1.50%
  - Replacement 1.5 Lien Notes - Treasury rate + 2.00%

- Replacement Notes would lower prepetition interest rates by approximately 5% for the First Lien Notes and 6% for the 1.5 Lien Notes.
  - Over $60 million in annual debt service savings

- Debt-for-equity swap with the Second Lien Notes, with $600 million Rights Offerings.

- No distributions for Senior Subordinated Notes.

- Eliminated $3 billion from balance sheet.

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Objectors' Opposition to Plan

- Argued that *Till* does not control in chapter 11 because there is an efficient market for chapter 11 loans.

- Pointed to market evidence to derive the cramdown rate.
  - Momentive had lined up $1 billion in exit financing at approximately 9-10%
  - Submitted expert reports supporting use of market rates (argued for rates of approximately 6-7.5%)

- Challenged Momentive's ability to meet its projections to argue the Plan was not feasible.

- Did not challenge the enterprise value presented by Momentive.

Ruling – Bankruptcy Court

- Approved the Plan's use of the *Till* formula for Replacement Notes.

- Per *Till* and *Valenti*, rejected reference to market rate for cramdown interest rate.
  - Overcompensation of creditors for profit and transaction costs
  - Purpose of cramdown rate is not to pretend a "new loan" was made by the creditor, which would include profits to the creditor

- Rejected objectors' arguments that there is a difference between chapter 11 and chapter 13 debtors under *Till*.

- Adjusted risk premiums upwards from 1.50% to 2.00% and 2.00% to 2.75% to account for use of treasury rate instead of prime rate.

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Why Momentive was Perfect Case for Application of *Till*

- $600 million Rights Offerings provided a market check on the enterprise valuation of Momentive and validation of its business plan.

- Significant deleveraging throughout the capital structure below the cramdown Replacement Notes
  - Exchange of Second Lien Notes
  - Cancellation of Senior Subordinated Notes

- Substantial equity cushion for the reorganized Momentive in relation to its post-emergence debt structure.

Effect of *Momentive* on Distressed Financing

- After Judge Drain's opinion was released, several articles were published which hypothesized that the *Momentive* ruling would cause lenders to stop giving new loans to highly distressed companies, for fear that the lenders could have their debt re-financed by the company at a below-market cramdown rate through a chapter 11 plan.
- A year after the *Momentive* decision, there is absolutely zero evidence in the market that the ruling has in any way negatively impacted lenders' willingness to loan to distressed companies.

Effect of *Momentive* on Distressed Negotiations

- The *Momentive* ruling is an important precedent for debtors negotiating with secured lenders about chapter 11 plans – debtors can threaten cramming down lenders with replacement debt at below-market rates if a mutually acceptable agreement is not reached.

- The case is currently on appeal to the Second Circuit; if Judge Drain's decision is affirmed on the merits, its utility to debtors in negotiations will continue to grow, since most large debtors could choose to file in the Southern District of New York to take advantage of this powerful precedent.