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S.D.N.Y. Affirms *MPM Silicones*' "Prime Plus" Formula for Cramdown Interest Rates, Likely Harming Creditor Recoveries

Craig M. Price, Michael Friedman, and Franklin H. Top, III*

In MPM Silicones, LLC, *the United States District Court for the Southern District of New York recently affirmed the bankruptcy court's decision establishing the "prime plus" formula as the appropriate interest rate required in connection with new notes issued to secured creditors under a cramdown plan of reorganization in the Southern District of New York. The authors of this article explain the decision and believe that it will likely serve to embolden debtors by increasing their power to threaten secured creditors with payment through replacement notes, with extended maturities and at reduced rates.*

The United States District Court for the Southern District of New York recently affirmed the bankruptcy court's decision in *In MPM Silicones, LLC*,[1] establishing Judge Drain's "prime plus" formula as the appropriate interest rate required in connection with new notes issued to secured creditors under a cramdown plan of reorganization in the Southern District of New York. This decision will likely have significantly negative consequences for secured creditors' future recoveries. At a minimum, it will likely severely lessen secured creditors' bargaining power in negotiating their treatment under plans of reorganizations. Given such potential harmful effects, all secured creditors should understand the implications of this decision.

THE PLAN AND THE BANKRUPTCY COURT DECISION

Judge Drain confirmed *MPM Silicones*' Chapter 11 plan (the "Plan"),[2]

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[1] Memorandum Decision, *In re MPM Silicones, LLC*, Case No. 14 CV 7471 (S.D.N.Y. May 4, 2015) (the "Decision").

[2] The Plan itself was structured around a so-called "death trap" provision. If First Lien Noteholders and 1.5 Lien Holders (collectively, "Senior Noteholders") accepted the Plan, they would receive cash for the full face amount of their claim, but would waive any claim to a $200

finding it "fair and equitable" despite the fact that it repaid senior secured noteholders through the distribution of replacement notes bearing interest rates far below the original issue interest rates and the current market rates for such debt.[3] In his holding, Judge Drain determined, citing two Chapter 13 cases,[4] that § 1129(b)(2)(A)(i)(II) of the Bankruptcy Code only requires an interest rate on deferred payments or replacement notes of "a risk free base rate" plus "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."[5] Judge Drain stated that "generally speaking, that risk adjustment should be between one percent and three percent."[6]

Believing that Judge Drain's "prime plus" formula vastly undercompensated them, senior noteholders appealed the bankruptcy court's decision to the district court.

THE DISTRICT COURT'S DECISION

On appeal, senior noteholders argued that they should be provided with a market rate of interest on the replacement notes. U.S. District Judge Briccetti disagreed, siding with Judge Drain and finding that a market rate of interest would overcompensate creditors, as any market rate would necessarily include amounts related to lenders' transaction costs and profit. A market rate would therefore allow creditors to "receive more than the present rate of [their] allowed claim." Judge Briccetti found "no good reason" why interest rates on the replacement debt should place Chapter 11 creditors in the same position as they would be in if they made a new loan.[7] Rather, Judge Briccetti held that the cramdown interest rate is meant "to put the creditor in the same economic

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million make-whole amount; if Senior Noteholders rejected the Plan and chose to pursue the make-whole amount, Senior Noteholders overwhelmingly rejected the Plan, seeking instead to pursue their claims for the make-whole amount.

[3] The 1.5 Lien Notes were issued at an interest rate of 10 percent and the First Lien Notes were issued at an interest rate of 8.875 percent. The Plan initially proposed to pay a 4.1 percent coupon on seven-year notes for the First Lien Noteholders, and a 4.85 percent coupon on seven-and-a-half year notes for the 1.5 Lien Noteholders.

[4] *Till v. SCS Credit Corp.,* 541 U.S. 465 (2004), and *In re Valenti,* 105 F.3d 55 (2d Cir. 1997).

[5] Transcript ("Tr.") of Hearing, *In re MPM Silicones, LLC*, et al., Case No. 14-22503-RDD (Bankr. S.D.N.Y. Aug. 26, 2014) at 68:5-10.

[6] Tr. at 68:10-12; 77:2-3.

[7] Decision at 18.

position that it would have been in had it received the value of its claim immediately."[8]

In reaching this decision, Judge Briccetti expressly chose not to follow caselaw from the Sixth Circuit, which had previously approved using a market rate in the Chapter 11 context.[9] He also ignored two prior precedents from other courts in the Second Circuit, finding that these cases did not explicitly require the use of a market rate either.[10]

With respect to the appropriate interest rate under Judge Drain's "prime plus" formula, senior noteholders further argued that the bankruptcy court improperly calculated the risk free rate by using the seven-year Treasury rate rather than the national prime rate, which had been used by the U.S. Supreme Court in *Till*. Finding that Judge Drain had used such rate because it is "often used as a base rate for longer-term corporate debt such as the [R]eplacement [N]otes," Judge Briccetti upheld the use of the seven-year Treasury rate.[11]

THE DECISION'S LIKELY NEGATIVELY EFFECTS ON SECURED CREDITORS' RIGHTS

As an initial matter, in many bankruptcy cases, appellate courts chose not to tackle the various issues appealed when a plan of reorganization has been at least partially consummated, finding such claims to be moot. Importantly, while the *MPM Silicones*' Plan appears to be substantially consummated, Judge Briccetti did not dismiss the appeals as moot. As a result, the confirmation decision, absent a reversal by the Second Circuit, now stands as controlling law in the Southern District of New York.

Judge Briccetti's decision will likely serve to embolden debtors by increasing their power to threaten secured creditors with payment through replacement notes, with extended maturities and at reduced rates. Debtor's increased power may significantly increase the cost of secured credit, as lenders price in a debtor's ability to forcibly extend maturities at below market rates.

Interestingly, the ABI has recently announced a series of proposals for the reform of Chapter 11, and in doing so, specifically suggested that the bankruptcy court's *MPM Silicones* decision be overturned. The ABI found

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[8] Decision at 17.

[9] *In re American HomePatient*, 420 F.3d 559 (6th Cir. 2005).

[10] *See In re 20 Bayard Views, LLC*, 445 B.R. 83, 107-08 (Bankr. E.D.N.Y. 2011), and *Mercury Capital Corp. v. Milford CT Assocs., L.P.*, 354 B.R. 1, 2 (D. Conn. 2006).

[11] Decision at 20.

Judge Drain's "prime plus" cramdown interest rate likely under-compensates secured creditors and recommended that *MPM Silicones*' formula approach be dropped for a more flexible, market-based approach. The ABI's proposed formula would utilize an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor, considering factors such as the debtor's industry, projections, leverage, revised capital structure and obligations under the plan. The ABI believes that such a formula will more accurately reflect the economic realities of the case.

Nevertheless, barring a reversal by the Second Circuit or a future amendment to the Bankruptcy Code, the *MPM Silicones* decision will stand as the governing law of all cases filled in New York City, and all secured creditors should understand its negative implications.