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Second Circuit Requires Consideration of Efficient Market for Chapter 11 Cramdown Interest Rates

Ruling overturns New York decision rejecting market-based approach.

Key Points:

- Court of Appeals for the Second Circuit requires courts to consider efficient market interest rate, if available, for purposes of chapter 11 "cramdown."
- Second Circuit decision overturns lower court ruling that used "formula approach" to determine appropriate chapter 11 cramdown interest rate.

The United States Court of Appeals for the Second Circuit has overturned a lower court ruling regarding the appropriate interest rate for purposes of cramming down a secured creditor under section 1129(b) of the Bankruptcy Code.[1] The Court of Appeals ruling in *In re MPM Silicones, L.L.C.*, 2017 U.S. App. LEXIS 20596 (2d Cir. Oct. 20, 2017) requires courts in the Second Circuit (New York, Connecticut, and Vermont) to apply an efficient market interest rate, if available, to the deferred payments a secured creditor is entitled to receive under chapter 11's cramdown provision.

Background

The Bankruptcy Code's Cramdown Provision

Section 1129(b) of the Bankruptcy Code provides that a plan of reorganization can be approved despite the existence of an impaired class that votes to reject the plan, so long as, among other things, the plan is "fair and equitable" with respect to such impaired, rejecting class. Section 1129(b)(2)(A)(i) states that one way of providing "fair and equitable" treatment is for a plan to provide that such creditors "retain the liens" securing their claims and "receive on account of such claim 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." The Bankruptcy Code does not provide guidance on how to determine the proper interest rate for such deferred cash payments, which must have a present value (as of the effective date of the plan) of at least the value of the creditor's interest in its collateral.

The Supreme Court's *Till* Plurality Adopts "Formula Approach" in Chapter 13 Case

In *Till v. SCS Credit Corp.*, 541 U.S. 465, 477 (2004), the US Supreme Court addressed the proper interest rate under chapter 13's cramdown provision. A plurality of the court adopted the two-step "formula approach," which "begins by looking to the national prime rate" and "then requires a bankruptcy court to adjust the prime rate" to reflect that "bankrupt debtors typically pose a greater risk of nonpayment than solvent commercial borrowers." The Supreme Court plurality noted that courts generally have approved of adjustments to the prime rate of 1% to 3%.

In adopting the formula approach, the *Till* plurality also criticized three alternative approaches — the coerced loan, presumptive contract rate, and cost of funds approaches — noting that each "is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value."[2] In particular, the *Till* plurality criticized the "coerced loan" theory on the grounds that the theory "requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors--an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans."

Despite criticizing bankruptcy courts' ability to consider evidence regarding the loan market, the plurality stated in a frequently cited footnote (known as "Footnote 14") that, "when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."

Bankruptcy Court in *MPM Silicones (Momentive)* Adopts *Till*'s "Formula Approach" in Chapter 11 Case

In *In re MPM Silicones, LLC*, 2014 Bankr. LEXIS 3926 (Bankr. S.D.N.Y. Sep. 9, 2014), two groups of secured lenders urged the Bankruptcy Court for the Southern District of New York to seize on the language in the *Till* plurality's footnote. The groups argued that, in chapter 11 cases, a court should first attempt to use a market interest rate and only turn to *Till*'s formula approach if an efficient market does not exist. However, the Bankruptcy Court declined to look to a market interest rate in the chapter 11 cramdown context and instead adopted *Till*'s formula approach.

Judge Robert D. Drain concluded that *Till* (as well as prior Second Circuit precedent) required that, "instead of applying a market-based approach," courts should use "a present value cramdown approach using an interest rate that takes the profit out, takes the fees out, and compensates the creditor under a formula starting with a base rate that is essentially riskless, plus up to a 1 to 3 percent additional risk premium, if any, at least as against the prime rate, for the debtor's own unique risks in completing its plan payments coming out of bankruptcy." In so finding, Judge Drain noted that the Supreme Court plurality in *Till* had explicitly rejected approaches such as the coerced loan approach that looked for evidence of a market interest rate.

Application of the formula approach in the *MPM Silicones* case led to cramdown interest rates of 4.1% for seven-year first lien notes and 4.85% for seven-and-a-half year "1.5 lien" notes.[3] Notably, if the first lien and 1.5 lien notes had voted in favor of the plan then the debtors would have paid them in cash, and to prepare for that possibility the debtors had gone into the market to secure exit financing to cover the lump-sum payments to the secured creditors. The debtors had been quoted interest rates ranging from 5% to more than 6% for such financing, higher than the cramdown interest rates that the Bankruptcy Court ultimately approved pursuant to its cramdown power.

Second Circuit Requires Market Interest Rate if an Efficient Market Exists

On October 20, 2017, the Court of Appeals for the Second Circuit overturned the ruling of the Bankruptcy Court. The Court of Appeals adopted a two-step approach requiring application of a market rate if an efficient market exists, and application of the formula approach if no efficient market exists, noting that “[m]any courts have relied on [*Till*’s] footnote 14 to conclude that efficient market rates for cramdown loans cannot be ignored in Chapter 11 cases.”

The Court of Appeals found that the Bankruptcy Court, on remand, is responsible for determining whether an efficient market existed; however, the court also suggested that the exit financing rates quoted to the debtor were evidence (though not necessarily dispositive) of the existence of such an efficient market.[4]

The Court of Appeals also appeared to disagree with the *Till* plurality’s assessment of bankruptcy courts’ ability to consider evidence of market interest rates: “We understand that the complexity of the task of determining an appropriate market rate will vary from case to case. In some cases the task will be straightforward, in others it will be more complex. But, at the end of the day, we have no reason to believe the task varies materially in difficulty from the myriad tasks which we regularly rely on the expertise of our bankruptcy courts to resolve.”[5]

Conclusion

The Bankruptcy Court’s adoption of the formula approach in 2014 generated significant debate among bankruptcy practitioners. The recent decision from the Court of Appeals, however, settles the debate with respect to courts in the Second Circuit, which are now required to consider if an efficient market exists when determining the appropriate cramdown interest rate in a chapter 11 case.

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Endnotes

1. Other issues considered by the Court of Appeals are outside the scope of this *Client Alert*.
2. The Supreme Court plurality explained that the coerced loan approach "requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors," the presumptive contract rate approach "improperly focuses on the creditor's potential use of the proceeds of a foreclosure sale," and the cost of funds approach "mistakenly focuses on the creditworthiness of the *creditor* rather than the debtor."
3. "[T]he rate for the first lien replacement notes should be the Treasury rate plus 2 percent, for an overall rate of 4.1 percent as of such date; and the rate for the 1.5 lien replacement notes should be the imputed seven-and-a-half-year Treasury note rate plus 2.75 percent, or a 4.85 rate." *In re MPM Silicones, LLC*, 2014 Bankr. LEXIS 3926, at *98-99 (Bankr. S.D.N.Y. Sep. 9, 2014).
4. The Court expressly stated the following: "We therefore conclude that the lower courts erred in categorically dismissing the probative value of market rates of interest. We remand so that the bankruptcy court can ascertain if an efficient market rate exists and, if so, apply that rate, instead of the formula rate. We arrive at no conclusion with regard to the outcome of this inquiry." *In re MPM Silicones, L.L.C.*, 2017 U.S. App. LEXIS 20596, at *37-38 (2d Cir. Oct. 20, 2017).

[5] The Court of Appeals went on to reject the debtors' assertion that the appeal of the cramdown interest rate was equitably moot. The Court of Appeals found that the secured lenders had diligently sought a stay of the plan of reorganization, and the Court of Appeals was "not persuaded that a payment of, perhaps, $32 million in annual payments over seven years, with no other redistribution from other creditors or third parties, would unravel the plan, threaten Debtors' emergence, or otherwise materially implicate [equitable mootness] concerns." *In re MPM Silicones, L.L.C.*, 2017 U.S. App. LEXIS 20596, at *37-38 (2d Cir. Oct. 20, 2017).