

# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

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## Feature

BY MICHAEL VITTI

### Is *Momentive* a Bigger Deal than Typically Reported, or Is It Much Ado About Nothing?



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Much has been written about the dispute in *Momentive*<sup>1</sup> over how to determine cramdown interest rates, but two key issues appear to get lost in the shuffle. First, the difference between market and cramdown interest rates when the debtor emerged from bankruptcy (Oct. 24, 2014) is about 2.5x higher than shown in the bankruptcy court's opinion (as of Aug. 26, 2014). This is why the dispute over how to determine cramdown rates in *Momentive* might be a bigger deal than typically reported. Second, the approach used to set cramdown rates in *Momentive* (base rate plus credit risk premium) can potentially result in the market-interest rate as of both dates while staying within the confines of the plurality's opinion in *Till*. This is why the dispute over how to determine cramdown rates in *Momentive* may nevertheless be much ado about nothing.

#### Aug. 26, 2014

The cramdown rate was set at 4.1 percent for the first-lien debt on Aug. 26, 2014.<sup>2</sup> This rate had three components: (1) 2.1 percent base rate; (2) 1.5 percent credit risk premium; and (3) 0.5 percent adjustment. The 2.1 percent base rate is equal to the seven-year Treasury rate, and the 1.5 percent credit risk premium reflects the credit risk associated with the debt. The 0.5 percent adjustment requires some explanation, however.

There was a debate over which base rate to use: the seven-year Treasury or prime. Neither choice is perfect on its face. On the one hand, the seven-year Treasury rate makes sense because it matches

the duration of the cramdown loan and because Treasury rates are often used when assessing corporate debt. On the other hand, the U.S. Supreme Court (plurality) in *Till*, when assessing the cramdown rate for a secured loan made to a married couple, used the prime rate.

The debate in *Momentive* mattered because there was a large difference between the seven-year Treasury (2.1 percent) and prime (3.25 percent) rates. Not surprisingly, the debtor wanted to pay based on the lower Treasury rate, whereas the creditors wanted to be paid based on the higher prime rate.

The debate over which base rate to use affects the valuation of the debt. The \$1.1 billion (face) first-lien debt would have been worth \$1.01 billion, or \$90 million below face, if the debtor's 3.60 percent proposed interest rate (based on no adjustment to the seven-year Treasury rate) prevailed. Alternatively, the first-lien debt would have been worth \$1.084 billion, or \$16 million below face, if the prime rate (results in 4.75 percent interest rate) was used.<sup>3</sup>

There was also an important nuance. The plurality in *Till* referenced a 1 to 3 percent credit risk premium range.<sup>4</sup> This credit risk premium was added to the prime rate, which also includes compensation for credit risk because the prime rate is charged to borrowers that may not pay back the loan. Thus, the aggregate credit risk premium referenced by the plurality in *Till* was greater than 1 to 3 percent.

The bankruptcy judge in *Momentive* took a middle-ground approach. He said some adjust-

<sup>1</sup> *In re MPM Silicones LLC*, No. 14-22503-rdd, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) ("*Momentive*"), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015), *appeal pending*, No. 15-1771 (2d Cir.).

<sup>2</sup> This article does not address the so-called 1.5-lien debt due to space limitations.

<sup>3</sup> The valuations assume that the loan has a seven-year term and is based on the 5 percent market-interest rate, which converts to a 5.06 percent discount rate because interest was paid on a semi-annual basis.

<sup>4</sup> *Till v. SCS Credit Corp.*, 541 U.S. 465, 480 (2004).

ment should be made to reflect the fact that the seven-year Treasury rate is a risk-free rate, whereas the prime rate includes some credit risk. However, he also said that the 1.15 percent difference that existed on Aug. 26, 2014, between the seven-year Treasury and prime rate was “somewhat anomalous.” He added 0.5 percent to the seven-year Treasury rate, which is somewhat less than half of the 1.15 percent difference between these two rates.

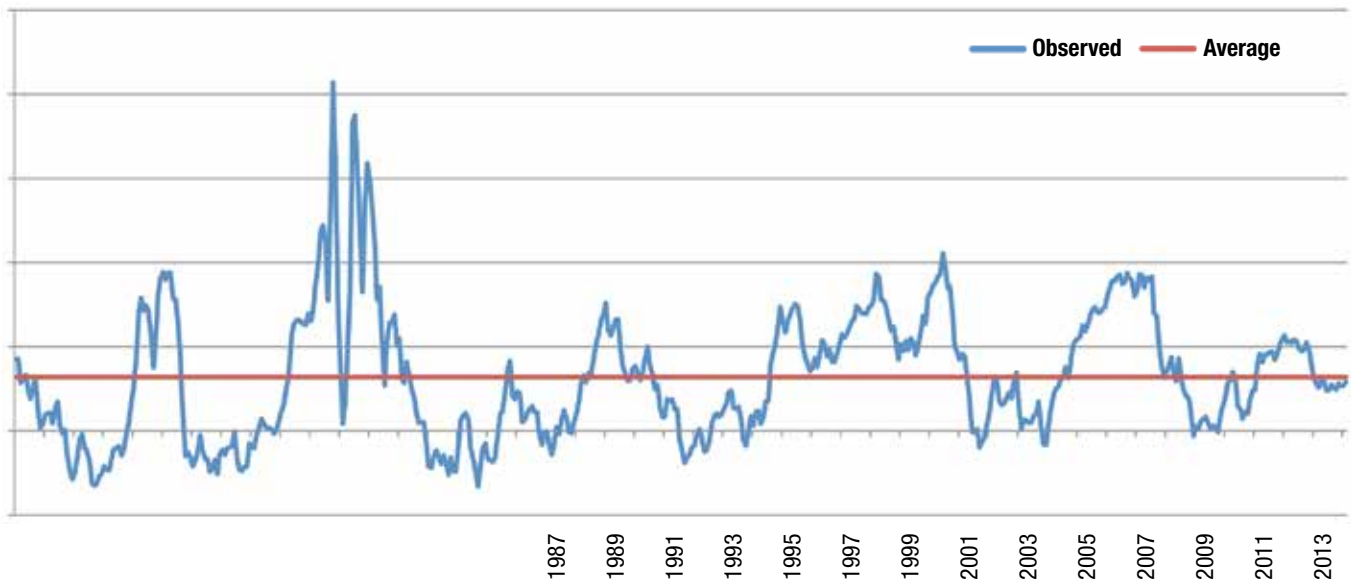
The bankruptcy judge’s 4.1 percent interest rate determination resulted in the first-lien debt being worth \$1.042 billion, or \$58 million below face. This valuation is between the \$90 million below face with no adjustment and \$14 million below face with the full adjustment.

The judge did not appear to have the full benefit of historical context. An analysis of the historical spread between the prime and seven-year Treasury rates does not appear to be in the trial record.<sup>5</sup> The discussion herein addresses this historical perspective.

The historical spread between the prime and the seven-year Treasury rate is volatile. Figure 1 is based on monthly averages between July 1969 and August 2014. The volatility of this spread was also not addressed by the Supreme Court in *Till*. There are periods when the spread is much higher than the 1.15 percent that existed on Aug. 26, 2014. One of those periods is when the cramdown rate was set in *Till*. Plan

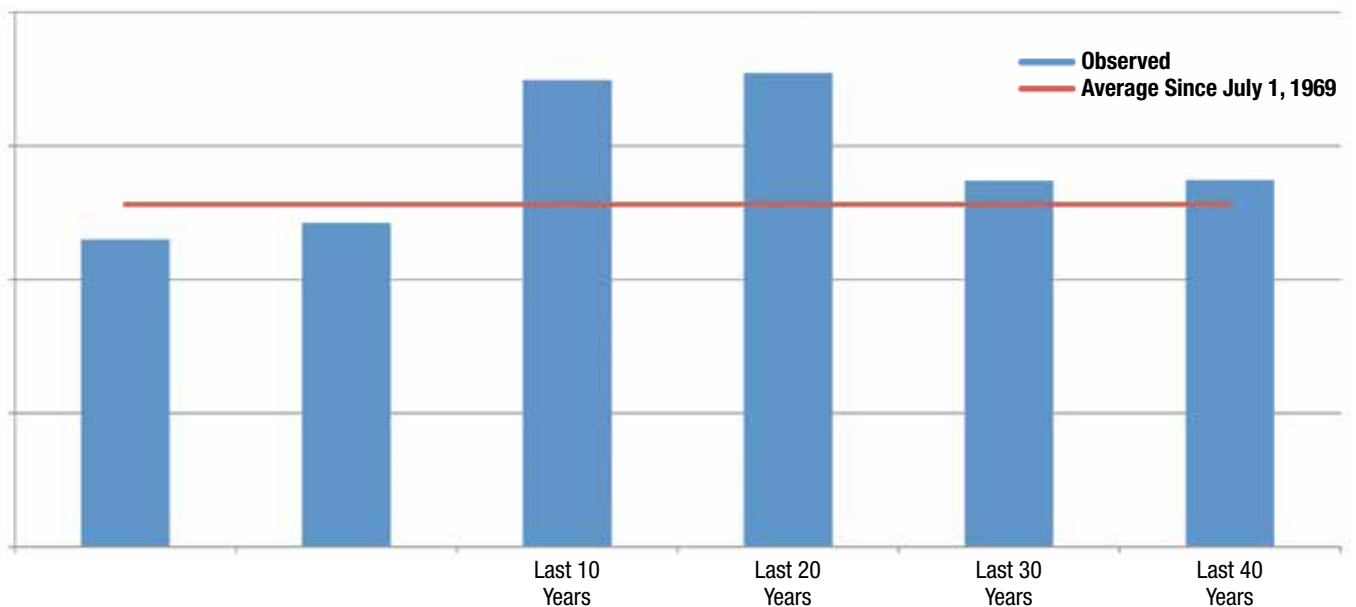
<sup>5</sup> Aug. 21, 2014, Transcript at 154-156.

**Figure 1: Spread: Prime vs. Seven-Year Treasury\***



\* Prime and Seven-Year Treasury rates (monthly averages) retrieved from the Federal Reserve Bank of St. Louis. Data for the prime rate is available at [research.stlouisfed.org/fred2/series/MPRIME](http://research.stlouisfed.org/fred2/series/MPRIME). Data for the seven-year Treasury rate is available at [research.stlouisfed.org/fred2/series/GS7](http://research.stlouisfed.org/fred2/series/GS7) (based on an interpolation).

**Figure 2: Spread: Prime vs. Seven-Year Treasury\***



\* Based on data within Figure 1.

confirmation was on June 27, 2000,<sup>6</sup> when the spread was over 3 percent.<sup>7</sup>

There are other periods when the spread is much lower than the 1.15 percent that existed on Aug. 26, 2014. Notably, one of those periods is when the Supreme Court issued its decision in *Till* on May 17, 2004, when the spread was *negative*. This date has no bearing on the analysis, but it highlights the volatility of the spread, as it went from well above to well below average during the course of *Till*.

As shown in Figure 2, the 1.15 percent spread difference that existed on the date that the bankruptcy court made its assessment in *Momentive* was somewhat *below* the historical average. This observation could suggest that the full 1.15 percent (instead of just 0.5 percent) should be included and an additional adjustment should be made to reflect the fact that the current spread was unusually low. It is possible to get very close to (or exceed) the market interest rate when the data from Figure 2 is used instead of the 0.5 percent adjustment that was made by the bankruptcy court that did not appear to have this information.

Figure 3 shows what happens when the cramdown rate is revised to use observed spreads between prime and the seven-year Treasury rate. This demonstrates why the debate over which approach to use when determining cramdown rates may be much ado about nothing as of Aug. 26, 2014.

## Oct. 24, 2014

The debtor in *Momentive* emerged from bankruptcy on Oct. 24, 2014, which is the effective date of *Momentive's* restructuring. The cramdown interest rate decreased from 4.1 percent on Aug. 26, 2014, to 3.88 percent on Oct. 24, 2014.<sup>8</sup> This appears to be due to the decline in the seven-year Treasury rate during the intervening period.<sup>9</sup>

6 *In re Till*, 301 F.3d 583, 596 n.1 (7th Cir. 2002).

7 Notably, the prime rate used in *Till* (8 percent) is 1.5 percent lower than the prime rate shown in Figure 1 (and other sources). Thus, it is possible that the "effective" spread in *Till* was much closer to 1.5 percent than 3 percent.

The market interest rate increased from 5 percent on Aug. 26, 2014, to 6.2 percent on Oct. 24, 2014. This observation is based on the following two-step process:

*Step 1: Identify the debtor's valuation of the first-lien debt.* The debtor determined the fair value (which is an "exit price" concept, and thus generally synonymous with "market value") of all its assets and liabilities due to fresh-start accounting rules. The first-lien debt was valued at \$957 million as of Oct. 24, 2014, or \$143 million below face.<sup>10</sup> This valuation appears to be based on the first date that the replacement securities traded, which was Oct. 31.<sup>11</sup>

*Step 2: Determine the market interest rate that is implied in the debtor's valuation.* This requires two calculations. First, determine the discount rate that converts the 3.88 percent cramdown rate into a \$957 million valuation: 6.32 percent. Second, determine the interest rate that results in a \$1.1 billion valuation when the discount rate is 6.32 percent: 6.2 percent.

It might be possible to arrive at the market rate (6.2 percent) as of Oct. 24, 2014, while staying within the confines of the plurality's opinion in *Till* by making two changes. First, use the 1.37 percent spread that existed as of Oct. 24. This results in a base rate of 3.25 percent.<sup>12</sup>

Second, increase the credit risk premium from 1.5 percent on Aug. 26, 2014, to 2.95 percent on Oct. 24. This results in the 6.2 percent market interest rate and keeps the credit risk premium under the 3 percent "cap" referenced by the plurality in *Till*.

8 *Momentive's* 2014 10K at 49.

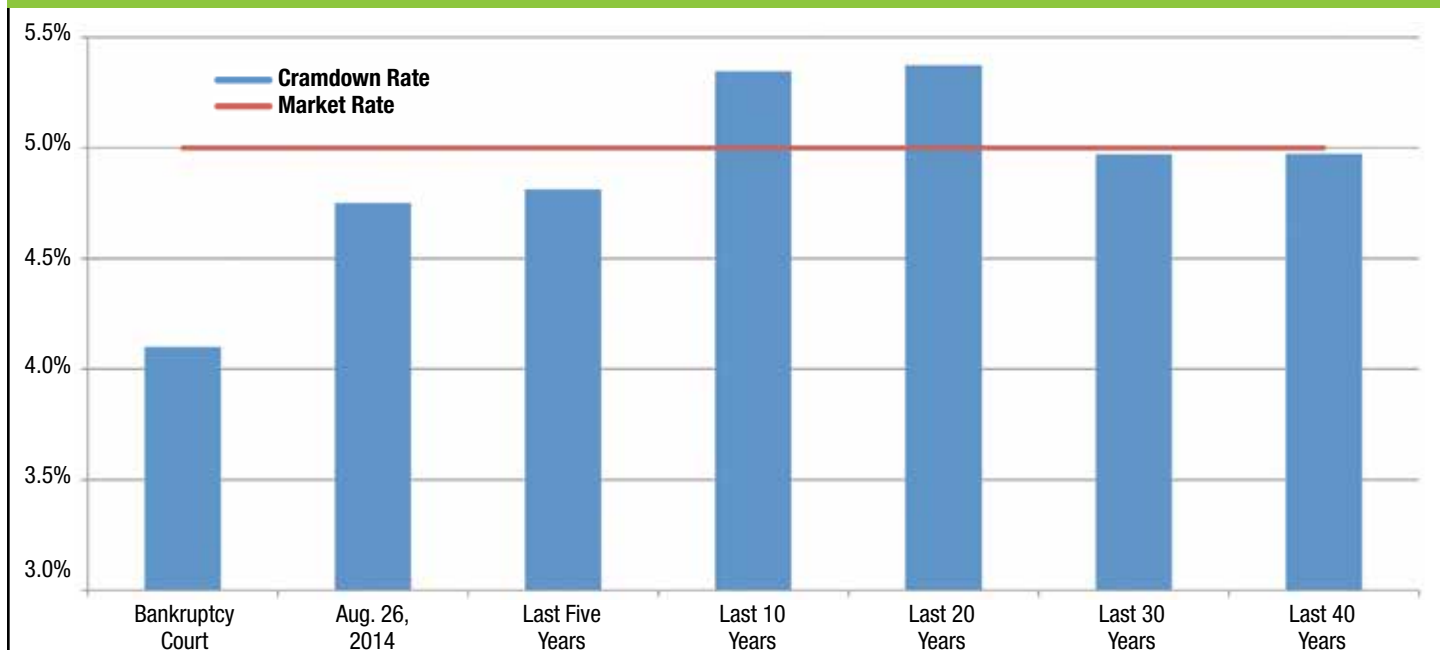
9 The cramdown rate appears to have been set as of Oct. 21 (Treasury yield was 1.88 percent), not Oct. 24.

10 The debtor implicitly made this disclosure when it showed that the carrying value was \$960 million as of Dec. 31, 2014. *Momentive's* 2014 10K at 66. This amount reflects amortization of the debt discount (difference between fair/market and face value) between Oct. 24 and Dec. 31. This period reflects 2 percent of the life of the loan that came due on October 2021, which provides enough information to impute the fair/market/carrying value as of Oct. 24: \$957 million.

11 The debtor appears to have used the market values on the first date that the replacement securities traded to arrive at the fair value as of Oct. 24. The first-lien debt was worth \$957 million on Oct. 31. The so-called 1.5-lien debt was worth \$202.5 million on Nov. 4, 2014. The combined value of \$1,159.5 billion is essentially the same as the \$1.159 billion value assigned to both securities as of Oct. 24, 2014. *Momentive's* 2014 10K at 52-53.

12 This calculates to 1.88 percent Treasury rate plus 1.15 percent spread as of Aug. 24, plus 0.022 percent increase in the spread between Aug. 26 and Oct. 24.

Figure 3: Cramdown Rate Based on Various Spreads of Prime and Treasury as of Aug. 26, 2014\*



\* Based on data within Figure 2.

The need to increase the credit risk premium by 1.45 percent between Aug. 26 and Oct. 24 appears to be equally due to market-related and debtor-specific reasons. The benchmark rate referenced at the confirmation hearing (Bank of America/Merrill Lynch Single B U.S. High-Yield Index)<sup>13</sup> increased by 0.7 percent between Aug. 28 and Oct. 24. This suggests that the remaining 0.75 percent increase was due to debtor-specific reasons.

## Lenders' Costs and Profits

A complicating factor to the previous discussion relates to lenders' costs and profits. The *Momentive* court stated that the market rate for a new loan is too high because it includes components (lenders' costs and profits related to arranging a new loan) that do not belong in the cramdown rate. Information related to these costs and profits also does not appear to be in the trial record.<sup>14</sup>

It does not seem likely that costs associated with arranging a new loan could have a material effect on the analysis. As previously discussed, the cramdown rate resulted in a value transfer of \$58 million on Aug. 26, 2014, and \$143 million on Oct. 24, 2014. It is difficult to posit a realistic scenario where fully burdened origination-related costs make a material dent in those amounts. For example, consider what appears to be a biased high assessment of origination-related costs. An army of 100 people working full-time for three months at a fully-burdened cost of \$200,000 per person (on an annual basis) only results in \$5 million of origination-related costs. This is less than 9 percent of the \$58 million value transfer as of Aug. 26, and less than 4 percent of the \$143 million value transfer as of Oct. 24.

That leaves profits, which can be open to interpretation. What are profits? The answer depends on one's own perspective. Assume that you bought a stock for \$100, received no dividends, sold it for \$110 one year later and the opportunity cost of equity was 10 percent. An accountant (and the Internal Revenue Service) will say you made a \$10 profit because you paid \$100 and sold it for \$110. An economist (and a valuation practitioner) will say that you broke even because an alternative investment was also expected to be worth \$110, which means you did not benefit from this particular investment. Said differently, your economic profit was zero. Thus, the debate appears to be over the definition of profits.

An economist's definition of profits appears to make more sense in the context of cramdown rates. A lender generates accounting-based profits when it borrows at X and lends at 2X. However, the difference between these two rates is often due to disparities in creditworthiness (the lender is more creditworthy than the borrower) and duration (the lender borrows short-term and lends long-term). Thus, the accounting-based profits are typically illusory because they violate a central tenet of asset valuation: The opportunity cost of capital is based on the asset's underlying risks, not the owner's risks and financing choices. An economist's definition of "profits" takes these issues into consideration.

The key nuance is presumably market efficiency. The expected economic profit for a loan issued in an efficient market is (near) zero because the interest will just cover

the opportunity cost of capital. The expected economic profit in an inefficient market, on the other hand, can be greater than zero.

## Conclusion

It appears that the approach used in the landmark case that transferred approximately 2.5x more value from certain creditors to the debtor than is typically reported can nevertheless arrive at the market rate. This observation suggests that using a market-based rate, which is recommended in the ABI Commission to Study the Reform of Chapter 11's Final Report,<sup>15</sup> may not be as controversial as it appears on the surface to those who believe cramdown rates should be below market.

The ability to reconcile the cramdown and market-rate approaches may have been foreshadowed by the plurality in *Till*, who stated:

Even more important, if all relevant information about the debtor's circumstances, the creditor's circumstances, the nature of the collateral, and the market for comparable loans were equally available to both debtor and creditor, then in theory the formula and presumptive contract rate approaches would yield the same final interest rate.<sup>16</sup>

The relevant information was available as of Aug. 26 and Oct. 24. The debtor had access to the relevant information when it valued the first-lien debt at \$957 million as of Oct. 24, which implied a market-interest rate of 6.2 percent. The underlying information used to value the debt on Oct. 24 appears to be the market interest rate for the replacement debt. This information was also available on Aug. 26.

The market-rate approach is clearly more analytically relevant than the presumptive contract-rate approach. The former is based on the debtor's post-petition financial condition, whereas the latter is based on the debtor's pre-petition financial condition. The only nuance that remains is the removal of origination-related costs and profits from the market-rate approach. However, the costs should be low when the cramdown loan is large (due to economies of scale) and the (economic) profits should be low when the market rate is identified in an efficient market. **abi**

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<sup>15</sup> The ABI Commission's *Final Report and Recommendations* is available in a downloadable format at [commission.abi.org](http://commission.abi.org). Printed copies can be purchased in the ABI Bookstore at [abi.org/bookstore](http://abi.org/bookstore).

<sup>16</sup> *Till* at 484.

<sup>13</sup> Aug. 21, 2014, Transcript at 237 (focus on yield-to-worst).

<sup>14</sup> *Id.* at 241 ("[N]one of this is in the record.")