Paul | Weiss

November 28, 2007

Solutia Bankruptcy Court Decision Limits Secured Creditors' Recoveries

In a recent decision[1] in a claims objection proceeding in the *Solutia* chapter 11 case, the Bankruptcy Court for the Southern District of New York set clear limits on the allowance of secured claims. Specifically, the Court reaffirmed the disallowance of unamortized OID in the bankruptcy context, ruled that an attempt by noteholders to de-accelerate debt that had become due automatically upon the filing of Solutia's chapter 11 petition violated the automatic stay, and declined to follow the holding in *In re Calpine Corp.*[2] that allowed noteholders to recover for "dashed expectations" where the debtor sought to repay debt prior to applicable call dates.

The controversy before the Court in *Solutia* involved determination of the amount of claims to be allowed in respect of the debtor's 11.25% Senior Secured Notes due 2009 (the "Notes"). It was conceded that the Notes, which were guaranteed by several affiliated debtors, were fully secured by various first and second liens. Accordingly, the noteholders had received postpetition interest at the "contract" rate throughout the chapter 11 case. Under the terms of the debtor's proposed reorganization plan, holders of the Notes were to receive payment of the allowed amount of their claims in full, in cash, upon the effective date of the plan. The noteholders, however, pursued several theories to increase such allowed amount, each of which Judge Beatty flatly rejected.

Because Solutia's proposed chapter 11 plan would result in unsecured creditors owning a majority of the reorganized company's common stock and the appointment of a new board of directors, the noteholders sought to take advantage of a change-in-control provision that required Solutia to purchase notes put to it at 101%. Accordingly, the noteholders included in their claims such premium as if the change of control proposed under the plan had occurred. Judge Beatty, however, had little difficulty in disposing of such an approach. She observed that the noteholders wanted their claims determined "by reference to the terms of the [proposed] Plan," whereas section 502(b) of the Bankruptcy Code commands that if an objection is raised, the court shall determine the amount of the claim "as of the petition date." Because allowance is "not a forward-looking process" the Court tossed the noteholders' claims based on events that were to occur on the plan's effective date.

---

[1] *In re Solutia Inc.,* 2007 WL 3376900, Chapter 11 Case No. 03-17949 (PCB)(Bankr. S.D.N.Y., Nov. 9, 2007)

[2] *In re Calpine Corp.,* 150 B.R. 529 (Bankr. S.D.N.Y. 2007).

1285 Avenue of the Americas
New York, New York 10019-6064
(212) 373-3000

1615 L Street, NW
Washington, DC 20036-5694
(202) 223-7300

Alder Castle, 10 Noble Street
London EC2V 7JU England
(44-20) 7367 1600

Fukoku Seimei Building 2nd Floor
2-2, Uchisawaicho 2-chome
Chiyoda-ku, Tokyo 100-001, Japan
(81-3) 3597-8101

Unit 3601, Fortune Plaza Office Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
(86-10) 5828-6300

12th Fl., Hong Kong Club Building
3A Chater Road, Central
Hong Kong
(852) 2536-9933

© 2007 Paul, Weiss, Rifkind, Wharton & Garrison LLP. In some jurisdictions, this advisory may be considered attorney advertising. Past representations are no guarantee of future outcomes.

Next, the Court tackled the more significant issue of how to compute the principal amount of the notes. It was undisputed that the notes were issued for $814.85 in cash per $1000 face amount with the $185.15 balance constituting original issue discount. The noteholders were attempting to collect as principal the aggregate face amount of the Notes, $223 million, whereas the debtor and its official creditors committee wanted "principal" limited to the amount advanced at issuance ($814.85 per $1000 note) with the balance treated as additional interest. This would have the effect of reducing the noteholders' recovery by an amount equal to the OID-interest that would accrue from the time of cashing out the noteholders under the plan through the stated maturity of the Notes in 2009, some $60 million. Here, too, Judge Beatty had little difficulty in rejecting the noteholders' position. Citing clear authority for the rule that unaccrued OID is not allowed in bankruptcy cases, the Court ruled that the "base amount" of the noteholders' claims is the amount actually advanced on the Notes plus OID accrued to the date of Solutia's chapter 11 filing. As to OID that accrued *during* the chapter 11 case on the noteholders' fully secured claims, Judge Beatty was spared ruling on whether the relevant cash collateral orders covered such amounts because the debtor and the creditors committee had conceded the point.

Judge Beatty also addressed the attempt by certain noteholders to "rescind" acceleration of the Notes caused by Solutia's chapter 11 filing. By de-accelerating, the noteholders hoped to assert damages for Solutia's "voluntary" prepayment of unmatured debt. The Notes contained the standard event of default language providing for *automatic* acceleration in the event of a bankruptcy. To bolster their claim for interest through the stated maturity of the Notes in 2009, an additional $60 million as described above, holders of a majority of the Notes sent a notice invoking their alleged right to waive the default caused by the chapter 11 filing and to "annul a declaration of acceleration and its consequences." Judge Beatty rejected the noteholders' position for several reasons. First, she noted that there had been no "declaration of acceleration" in the first place that could be revoked; the Notes had become due automatically in accordance with their terms. Moreover, she ruled that the noteholders' notice was void because it violated the automatic stay; specifically, the attempt to reverse the maturity of the Notes was part of an effort to "assess" a claim in violation of section 362(a)(6) of the Bankruptcy Code. It was clear to the Court that the noteholders were attempting to take advantage of Judge Lifland's decision in *Calpine* awarding damages for loss of the originally bargained-for stream of payments when notes are paid before maturity. Judge Beatty, however, bristled at the suggestion that the Court should "supply what is absent" in the provisions of the Notes. They provided for automatic acceleration upon a bankruptcy filing without the payment of any make-whole or other yield protection, features which could have been negotiated for by the parties to the underlying indenture.

After having "dashed the expectations" of the noteholders that they could increase the amount of their fully secured claims under various theories, the Court went on to rule that the noteholders could not recover the amounts she had disallowed from the various affiliated debtors that had guaranteed Solutia's payment of the Notes. Judge Beatty observed that "[i]f the Debtors are paying the full amount of the allowed claim, there remains no claim to assert against the Subsidiary Guarantors regardless of their solvency."

In addition to Judge Beatty's rulings on the merits of the arguments raised by the noteholders, practitioners should be mindful of two additional points addressed by the Court in passing. *First,* when negotiating adequate protection payments in the form of postpetition interest, care should be taken to either compute such interest to include OID, or to reserve the right to recover such additional interest at a later point in the case. *Second,* although she did not need to reach the issue because of her ruling on the merits, Judge Beatty concluded that the underlying proofs of claim "probably" were not sufficiently explicit to include a claim for "expectation

damages” related to interest accruing from the plan effective date through the original stated maturity of the Notes. Thus, counsel should assume that boilerplate, general descriptions of “other unliquidated amounts” and the like may not be effective to preserve the right to seek “expectation damages” and other amounts in addition to principal, interest, premiums and fees.

* * * * *

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be addressed to:

Alan W. Kornberg (212) 373-3209
Andrew N. Rosenberg (212) 373-3158
Brian S. Hermann (212) 373-3545