"Trade Away!"

Bankruptcy Court for the Southern District of New York Decides That Original Issue Discount From Fair Value Exchanges Is Allowable in Bankruptcy

Richard L. Wynne
Lance Miller

Debt exchanges have long been utilized by distressed companies to address liquidity concerns and to take advantage of beneficial market conditions. A company saddled with burdensome debt obligations, for example, may seek to exchange existing notes for new notes with the same outstanding principal but with borrower-favorable terms, like delayed payment or extended maturation dates (a "Face Value Exchange"). Or the company might seek to exchange existing notes for new notes with a lower face amount, motivated by discounted trading values for the existing notes (a "Fair Value Exchange"). Under either scenario, for tax and accounting purposes, a debt exchange will create "original issue discount" ("OID"), equal to the difference between the face amount of the new notes and the value generated by the exchange for the company (i.e., the fair market value of the old notes). For tax and accounting purposes, OID is treated as interest that is amortized over the life of the note, with the face amount scheduled to be paid on maturity. When a company files for bankruptcy relief, however, treating unaccrued OID as interest arguably should result in its complete disallowance, because the Bankruptcy Code has a general rule—section 502(b)(2)—disallowing "unmatured interest."

To the investors who agreed to participate in the company's debt exchange—and thereby supported prepetition efforts to avoid bankruptcy in the first place—disallowing unaccrued OID seems manifestly unfair, punishing cooperative creditors for assisting a struggling company in seeking to avoid bankruptcy. Both the Second and Fifth Circuit Courts of Appeal have respected these concerns, holding primarily on policy grounds that unaccrued OID from Face Value Exchanges should not be disallowed, in order to encourage out-of-court restructuring. *See In re Chateaugay Corp.*, 961 F.2d 378 (2d Cir. 1992); *In re Pengo Indus., Inc.*, 962 F.2d 543 (5th Cir. 1992). Until recently, however, no court had decided whether the same rule should apply to Fair Value Exchanges.

The wait is over. In a recent decision—*In re Residential Capital, LLC*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013)—Judge Martin Glenn of the U.S. Bankruptcy Court for the Southern District of New York held that OID created from a prepetition Fair Value Exchange should be treated the same as OID arising from Face Value Exchanges, that is, as an allowed claim in bankruptcy despite section 502(b)(2)'s disallowance of claims for unmatured interest. If interpreted broadly and adopted by other courts, this decision will bring certainty to the markets that OID resulting from a debt-for-debt exchange will be allowed in bankruptcy, regardless of how the exchange is structured.

***Chateaugay* and Face Value Exchanges**

The long-standing rule allowing claims for unaccrued OID in a bankruptcy case for Face Value Exchanges arose from the Second Circuit's decision in *Chateaugay*. *Chateaugay* involved a prepetition Face Value Exchange that exchanged old notes trading at a discount to par with new notes in the same principal amount but with restructured payment terms. Unfortunately, the exchange was not enough to stave off the debtors' financial troubles, and after the debtors filed for bankruptcy relief in New York, the bankruptcy court held that the OID created by the exchange was subject to disallowance under section 502(b)(2) as unmatured interest. The bankruptcy court reasoned:

> In actuality, OID is nothing more or less than additional interest associated with a particular debenture. When purchasing debentures the "market" sets the appropriate rate of interest to compensate the purchaser for allowing the issuer to use the proceeds of the issue for a specified period of time, and for the various risks associated with [the] lending process such as expected inflation and the risk of nonpayment. If the proceeds from a particular issue are less than the face amount of the debentures, the "market" is telling the issuer that the stated rate of interest is too low, and the differential between consideration paid for the debenture and the amount received by the purchaser at maturity is intended to compensate the purchaser for buying a debenture with a stated interest rate below market levels.

In re Chateaugay Corp., 109 B.R. 51, 55 (Bankr. S.D.N.Y. 1990), *aff'd*, 130 B.R. 403 (S.D.N.Y. 1991), *aff'd in part, rev'd in part*, 961 F.2d 378 (2d Cir. 1992). The U.S. District Court for the Southern District of New York affirmed the bankruptcy court's decision without substantive discussion.

On further appeal, the Second Circuit Court of Appeals reversed, due largely to policy concerns that disallowing unamortized OID would discourage "the speedy, inexpensive, negotiated resolution of disputes" out of court. The decision was perhaps also motivated by the prevailing belief that the lower courts' decision to disallow unaccrued OID (known as "LTV risk" because one of the debtors in *Chateaugay* was the LTV Corporation) had already increased bankruptcy filings that otherwise could have been avoided.

Shortly after the Second Circuit's decision in *Chateaugay*, the Fifth Circuit Court of Appeals in *Pengo* also endorsed the notion that, for policy reasons, the Bankruptcy Code's prohibition against unmatured interest should not apply to OID arising from a Face Value Exchange.

The decisions in *Chateaugay* and *Pengo* were expressly limited to OID arising from Face Value Exchanges. Both courts specifically left open the question of whether the same result should apply to OID arising from Fair Value Exchanges. In *Chateaugay*, the Second Circuit wrote in dicta that "[t]he bankruptcy court's decision might make sense in the context of a Fair Value exchange, where the corporation's overall debt obligations are reduced." The Fifth Circuit similarly noted in *Pengo* that "we express no opinion as to whether a Fair Value exchange creates OID not allowed under § 502(b)(2)." Parties were not quick to challenge this question, leaving markets in a relative state of uncertainty regarding Fair Value Exchanges. This question was answered recently by the bankruptcy court in *Residential Capital*.

Residential Capital

The debtors in *Residential Capital* initiated a prepetition Fair Value Exchange whereby they exchanged $6 billion (face amount) in old unsecured notes for approximately $4 billion (face amount) in new secured notes, plus $500 million in cash. Specifically, participants in the exchange traded $1,000 face principal amount of the old notes for $800 face value of the new notes, where the market value of the old notes was $650 per $1,000 face amount of each note.

In the debtors' bankruptcy, the official committee of unsecured creditors (the "committee") sought a determination that the unaccrued OID (totaling approximately $377 million) should be disallowed as unmatured interest. The committee distinguished *Chateaugay* by arguing that disallowing the OID in this case would not chill future similar debt exchanges:

> Here, among other things, the Exchange traded unsecured notes for a lower face amount of fundamentally different secured and structurally senior obligations. Holders were given ample incentives to tender, including almost certainly improved treatment in the event of a bankruptcy, even with OID treated as unmatured interest pursuant to Bankruptcy Code section 502(b)(2).

Plaintiffs' Phase I Post-Trial Brief, *Official Committee of Unsecured Creditors v. UMB Bank, N.A.*, Adv. No. 13-01277, at *11 (Bankr. S.D.N.Y. Nov. 1, 2013) [Dkt. No. 186].

At the outset, the court held that a trial would be required to determine, as a matter of fact, whether the debt exchange in this case implicated the same policy considerations underlying *Chateaugay* and *Pengo*. At trial, the expert for the committee testified that the enhanced yield, security, and seniority of the new notes provided noteholders with "ample economic incentives to participate in the Exchange Offer regardless of OID in bankruptcy." Direct Testimony of John D. Finnerty, Ph.D., *Official Committee of Unsecured Creditors v. UMB Bank, N.A.*, Adv. No. 13-01277, at *21 (Bankr. S.D.N.Y. Oct. 8, 2013) [Dkt. No. 127]. According to the committee's expert, as a result of these enhancements, "[t]he level of recoveries projected by the credit analysts, which was considerably less than 100%, suggests that the treatment of OID in bankruptcy would not have been a consideration for the note holders in deciding whether or not to participate in the Exchange Offer." *Id.* at *24.

In contrast, the noteholders' expert noted that the offering memorandum for the debtors' debt exchange did not mention the risk that OID could be disallowed in a bankruptcy, and he testified that the market did not place "significant value" on the new liens or guarantees provided under the exchange. Sworn Witness Statement of P. Eric Siegert, *Official Committee of Unsecured Creditors v. UMB Bank, N.A.*, Adv. No. 13-01277, at *16 (Bankr. S.D.N.Y. Oct. 9, 2013) [Dkt. No. 138]. With respect to policy, the noteholders' expert also testified that:

> [t]he market has functioned with substantial disregard to OID related to restructurings since the *Chateaugay* Decision. Any modification to the status quo would have widespread impact on the way in which debt is treated and traded and would be inconsistent with the realities of the market, making far more difficult the task of delevering over-leveraged companies. In fact, the mere assertion of the Committee's claim has already had such a real world effect on a multi-billion dollar exchange presently under negotiation where the bondholders have categorically refused to consider a Fair Value Exchange.

Id.

Following trial, the bankruptcy court determined that the OID arising from the debtors' Fair Value Exchange should be treated in the same fashion as OID arising from a Face Value Exchange. Specifically, the court found that "there is no meaningful basis upon which to distinguish between the two types of exchanges," pointing to admissions by the committee's expert that "distinguishing between face value and fair value exchanges is 'somewhat arbitrary' " because issuers consider the same factors in deciding whether to implement either type of exchange:

> Dr. Finnerty acknowledged that nearly all of the features that companies consider in connection with a debt-for-debt exchange can be used in both face value and fair value exchanges: (1) granting of security in the issuer's collateral; (2) interest rate; (3) maturity date; (4) payment priorities; (5) affiliate guarantees; (6) other lending covenants; (7) redemption features; (8) adding or removing a sinking fund or conversion feature; and (9) offering stock with the new debt. . . . Other than changing the face value of the bond (which is not possible in face value exchanges), an issuer "could adjust every other factor" available to it.

Id. at 588. Accordingly, the court reasoned that since the Fair Value Exchange in this case was indistinguishable from Face Value Exchanges, the holding from *Chateaugay* should apply in both instances.

Although the court's reasoning was arguably based on the specific facts underlying the debtors' exchange, its holding was considerably broader: "The Court thus concludes that there is no commercial or business reason, or valid theory of corporate finance, to justify treating claims generated by face value and Fair Value Exchanges differently in bankruptcy." *Id.*

Key Lessons

If the decision in *Residential Capital* is broadly adopted by other courts, it would provide much-needed certainty to the markets for distressed debt. Broad acceptance of the decision would provide issuers and bondholders alike with greater certainty that any OID arising from a debt-for-debt exchange will be treated as an allowed claim in the event of a bankruptcy filing. *Residential Capital* thus removes an important stumbling block to distressed companies seeking to retire or restructure burdensome debt through an exchange. It will likely also remove one reason why some holders in the past have refused to participate in exchanges. On the company side, it may also reduce pressure for a distressed company to provide significant credit enhancements to entice participation in a debt-for-debt exchange.

For those seeking to challenge allowance of unamortized OID in the future, *Residential Capital* will present a significant hurdle. Decisions from the U.S. Bankruptcy Court for the Southern District of New York are particularly influential regarding complex chapter 11 issues, and Judge Glenn's decision in *Residential Capital* is thoroughly reasoned. Notably, however, the decision was based in part on expert testimony that there is no meaningful difference between a Fair Value Exchange and a Face Value Exchange. Parties seeking a different result may attempt to bring forth credible experts with a different opinion or to distinguish the facts from those present in *Residential Capital*.