

CLIENT UPDATE

BANKRUPTCY COURT RULES OID GENERATED IN FAIR MARKET VALUE DEBT EXCHANGE SHOULD BE ALLOWED

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On November 15, 2013, Judge Martin Glenn of the Bankruptcy Court for the Southern District of New York held that original issue discount (“OID”) created in a prepetition “fair market value” debt exchange is not disallowable in bankruptcy.¹ This noteworthy ruling provides important and long-awaited guidance for the investing community on the question left open by the Second Circuit’s 1992 ruling in *LTV Corp. v. Valley Fidelity Bank & Trust Co. (In re Chateaugay Corp.)*.²

BACKGROUND

OID is a form of “deferred interest” that is generated when a bond is issued for less than its face value. The discount is the difference between the face value of a bond and the price paid to the issuer. For instance, if a company issues a zero coupon bond with a face value of \$100 at an issue price of \$80, the OID for the bond is \$20. Although OID is only payable at maturity, for tax and accounting purposes, OID is amortized over the life of the bond. In a debt exchange, the issue price of the new debt is generally determined by reference to its market value at the time of issuance.

¹ *In re Residential Capital LLC*, No. 12-12020, 2013 Bankr. LEXIS 4844 (Bankr. S.D.N.Y. Nov. 15, 2013), available at http://www.nysb.uscourts.gov/sites/default/files/opinions/228358_5772_opinion.pdf

² 961 F.2d 378 (2d Cir. 1992).

In 2008, Residential Capital LLC undertook a series of restructuring transactions, including the exchange of \$6 billion of its outstanding unsecured notes for approximately \$4 billion of new junior secured notes and \$500 million in cash. Based on initial trading, the issue price for each \$1,000 of new junior secured notes was determined to be \$613.75, generating aggregate OID of approximately \$1.5 billion.

On May 14, 2012, ResCap filed for bankruptcy. As of the filing date, the unamortized OID on the junior secured notes was \$386 million. The creditors' committee appointed in the case sought to disallow this portion of the junior secured noteholders' claim as a claim for unmatured interest.

OID GENERATED IN FACE VALUE EXCHANGES IS NOT DISALLOWABLE

Section 502(b)(2) of the Bankruptcy Code provides that a claim shall be allowed "except to the extent that . . . such claim is for unmatured interest."³ The general rule is that unamortized OID constitutes "unmatured interest" under section 502(b)(2) and must be disallowed.

In *Chateaugay*, the Second Circuit established an exception to this rule for obligations issued in a prepetition "face value" debt exchange, where existing debt is exchanged for an equal principal amount of new debt. The Second Circuit held that OID generated in a face value exchange is not disallowable under section 502(b)(2). The court based its ruling on the strong bankruptcy policy favoring out-of-court restructuring: "If unamortized OID is unallowable in bankruptcy, and if exchanging debt increases the amount of OID, then creditors will be disinclined to cooperate in a consensual workout that might otherwise have rescued a borrower from the precipice of bankruptcy."⁴ The Second Circuit limited its ruling to face value exchanges and noted that a different result may be warranted in the case of a fair market value exchange where existing debt is exchanged for a lesser principal amount of new debt, resulting in an overall reduction in the issuer's debt obligations.⁵

CHATEAUGAY APPLIES TO FAIR MARKET VALUE EXCHANGES

Until now, no court had determined whether OID generated in a fair market value exchange is disallowable in bankruptcy, causing uncertainty in the marketplace. Judge Glenn, in applying *Chateaugay* to fair market value exchanges, found that there was no reason to distinguish fair market exchanges from face value exchanges.

³ 11 U.S.C. § 502(b)(2).

⁴ *Chateaugay*, 961 F.2d at 382.

⁵ *Id.*

The court observed that nearly all of the features that companies consider applying to a debt exchange can be used in both fair market and face value exchanges (*e.g.*, granting a security interest, modifying interest rates and maturity dates, changing payment priorities). Essentially, the only term that can be modified in a fair market value exchange but not in a face value exchange is the principal amount of the debt. In addition, the court noted that the market value of the old debt in both types of exchanges likely reflects a discount to its face value; OID is created for tax purposes in both types of exchanges (and *Chateaugay* held that OID for tax purposes is not determinative of its treatment in bankruptcy); and there are concessions and incentives involved in both types of restructuring efforts.

The court also explained that the Bankruptcy Code is not clear on the issue of whether OID generated in a fair market value exchange is disallowable in bankruptcy and “courts should provide predictability to parties in planning transactions.”⁶

IMPLICATIONS

Judge Glenn’s decision recognizes the importance of fair market value debt exchanges as a restructuring strategy for distressed companies and their investors and provides much-needed guidance on a significant issue in this market.

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Please do not hesitate to contact us with any questions.

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⁶ *Residential Capital*, 2013 Bankr. LEXIS 4844, at *100.