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ResCap Bankruptcy Judge Holds That Unamortized Original Issue Discount In "Fair Value" Debt-for-Debt Exchange Not Disallowed Under § 502(b)(2)

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In a case of first impression, Bankruptcy Judge Martin Glenn for the Southern District of New York Bankruptcy Court in *In re Residential Capital, LLC* held that unamortized original issue discount ("OID") created in a "fair value" debt-for-debt exchange was not disallowed under Bankruptcy Code § 502(b)(2).[1]

OID results when a note is issued for less than its face amount. The discount, which compensates for a below-market stated interest rate, is amortized over the life of the note for accounting and tax purposes with the face value typically paid at maturity. Any unamortized OID is generally disallowed as "unmatured interest" under Bankruptcy Code § 502(b)(2).

Notwithstanding this general rule, the Second Circuit Court of Appeals held in *In re Chateaugay Corp.* that OID created by a "face value" debt-for-debt exchange was not disallowed as unmatured interest under § 502(b)(2), but stated that disallowance "might make sense" in a "fair market value exchange, where the corporation's overall debt obligations are reduced."[2]

A "face value" exchange involves the substitution of a new debenture modifying the terms or conditions of the existing note but not reducing the principal amount of the debt. Such an exchange may benefit the issuer by extending repayment dates or lowering the interest rate while the issuer remains liable for the full amount of the borrowed funds. In a "fair value" exchange, an existing debenture is exchanged for one with a reduced principal amount, typically at an approximation of the market value of the existing debt. This type of exchange allows the issuer to reduce its outstanding debts.

When old notes are trading at a depressed price (which is typically the case in a debt-for-debt exchange), a "face value" exchange will create OID for tax purposes as the lower trading value of the old notes will be deemed the issue price. In *Chateaugay*, the Second Circuit rejected the argument that OID tax treatment was determinative of bankruptcy disallowance treatment under § 502(b)(2).[3] The Second Circuit recognized strong bankruptcy policy grounds for not disallowing OID in a "face value" exchange because it would discourage "a consensual workout that might otherwise have rescued a borrower from the precipice of bankruptcy" and "grant[] a corresponding windfall both to holdouts who refuse to cooperate and to an issuer that files for bankruptcy subsequent to a debt exchange."[4] The Second Circuit further found that the exchange did "not change the character of the underlying debt, but reaffirm[ed] and modifie[d] it."[5]

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In 2008, ResCap exchanged $1,000 face amount of old unsecured notes (the "Old Notes") for $800 face amount of junior secured notes (the "JSNs"). Holders of the Old Notes had the option to elect to receive cash in lieu of the JSNs pursuant to a modified Dutch auction, at which the clearing price was $650 per $1,000 principal amount of JSNs. The first day of trading established an issue price of $613.75 for the JSNs. Because the issue price was below the face amount of the JSNs, the exchange created OID for tax purposes, which remained unamortized in the amount of $386 million as of the petition date.

The exchange benefited ResCap by reducing its overall debt obligations and extending its debt maturities. Similarly, while the JSNs had a reduced face amount of $800 per $1,000 of Old Notes, the JSNs were secured and structurally senior to the Old Notes. The benefits of the JSNs became clear in the bankruptcy case as the JSNs will achieve a greater recovery than the Old Notes under the proposed plan despite the reduced face amount of the JSNs. Holdouts will recover only 36.3% or $363 on $1,000 par amount of Old Notes. In contrast, $800 of JSNs is projected to recover $840.

The creditors' committee sought to distinguish *Chateaugay* arguing that the exchange at issue more closely resembled two separate transactions: (1) the purchase of outstanding debt at fair market value, and (2) the sale of new bonds at fair market value with new terms including security. In addition, the committee argued that disallowing OID in this case would not discourage consensual workouts or result in a windfall to holdouts, which were the principal concerns cited by the Second Circuit in *Chateaugay*, because the JSNs would still receive greater recoveries than the Old Notes.

Judge Glenn rejected the committee's argument, found that *Chateaugay* controls, and held that the same rule on allowance of unamortized OID applies to both face value and fair value exchanges. The Court concluded that, under *Chateaugay*, creation of OID for tax purposes is irrelevant for disallowance purposes under § 502(b)(2). Next, Judge Glenn explained that there is "no meaningful basis" to distinguish between face value and fair value exchanges. In both types of exchanges, the issuer can adjust all of the relevant features other than the face value of the note, including: "(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." Further, in both types of exchanges, the market value of the old debt is likely depressed, OID is created for tax purposes, and there are concessions and incentives. Importantly, both types of exchanges "offer companies the opportunity to restructure out-of-court, avoiding the time and costs—both direct and indirect—of a bankruptcy proceeding." In sum, both types of exchanges are identical (other than reduced face value for the new notes) and there is no reason to distinguish between them.

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In addition, the Court rejected the committee's argument that the plain language of § 502(b)(2) required disallowance stating that the term "unmatured interest" is undefined making application of the plain language rule "debatable." The Court also reasoned that it must adopt a rule providing predictability to market participants and not dependent on whether the noteholders or debtors got a "good deal" in the bankruptcy.

Based on all of the foregoing, the Court refused to reduce the JSNs' claim by the amount of unamortized OID under § 502(b)(2). This decision provides some comfort to holders to participate in a "fair value" debt-for-debt exchange and may make it easier for issuers to reduce their debt through consensual, out-of-court workouts.

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[1] *See* Memorandum Opinion, and Findings of Fact and Conclusions of Law, After Phase I Trial, *Official Committee of Unsecured Creditors v. UMB Bank, N.A. (In re Residential Capital, LLC),* Case No. 12-12020(MG), Adv. Nos. 13-01277(MG), 13-01343(MG) (Bankr. S.D.N.Y. Nov. 15, 2013) [Doc. No. 5772], pp. 37-41, 53-59.

[2] *LTV Corp. v. Valley Fidelity Bank & Trust Co. (In re Chateaugay Corp.)*, 961 F.2d 378, 381-83 (2d Cir. 1992); *see also Texas Commerce Bank, N.A. v. Licht (In re Pengo Indus., Inc.)*, 962 F.2d 543, 547-551 (5th Cir. 1992) (following *Chateaugay*)

[3] 961 F.2d at 383.

[4] *Id.* at 382.

[5] *Id.*

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