

Insolvency and Restructuring Update

ResCap Court Holds that Debt Issued in Fair Value Exchanges Will Not be Discounted for OID in Bankruptcy

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On September 15, 2013, Judge Martin Glenn of the United States Bankruptcy Court for the Southern District of New York issued an opinion in the Residential Capital (“**ResCap**”) bankruptcy that will provide greater certainty to creditors of distressed entities that agree to fair value debt-for-debt exchanges. In addition to other issues he addressed, Judge Glenn found that original issue discount (“**OID**”) created in a fair value debt-for-debt exchange for tax purposes will not be disallowed as unmatured interest for bankruptcy purposes. Judge Glenn’s findings on the treatment of exchange-related debt fill in a gap in the case law left by the Second Circuit’s *Chateaugay* decision, and may positively impact the market for distressed debt as well as the ability of distressed borrowers to refinance their debt going forward.

Central Issues and Relevant Precedent

The key matter addressed by Judge Glenn was the treatment of OID in bankruptcy. OID is a type of “deferred interest” created when debt is issued for less than the face value the borrower contracts to pay at maturity.¹ In addition to OID created at the time of the issuance of new debt, OID can also arise for tax purposes in debt-for-debt exchanges, including both face value exchanges and fair value exchanges. A face value exchange occurs when a debtor exchanges an existing debt instrument for one with new terms, but in the same principal amount. A fair value exchange occurs when a debtor exchanges an existing debt instrument for one with a reduced principal amount, thus reducing its overall debt obligations. In either case, OID is created at the time of issuance of the new debt if its face amount is greater than its trading price. If, for example, debt issued in an exchange (either face or fair value) has a face amount of \$100 but trades at \$80, the new debt would be deemed to have been issued with \$20 of OID. Although it is well-settled that these transactions give rise to OID that can generally be deducted for tax purposes by the issuer (subject to certain limitations for high-yield debt), the treatment of OID related to debt exchanges in bankruptcy proceedings has been less clear.

Bankruptcy courts generally do not allow a creditor to include OID in an unsecured claim against the bankruptcy estate, as it is considered unmatured interest that is disallowed under the Bankruptcy Code.² Therefore, when debt is issued at less than face value and the borrower files for bankruptcy prior to the maturity of the loan, the creditor would have a claim only for the unpaid principal amount in fact loaned to the borrower and any accrued and unpaid interest (including amortized OID) as of the petition date, not the principal face amount of the debt instrument (which includes unamortized OID).

The Second Circuit considered the treatment of OID arising from face value exchanges in *In re Chateaugay Corp.*³ and held that although for tax purposes OID was created, there was no new OID created for bankruptcy purposes. Therefore the creditor’s claim was allowed in the full face amount without a discount for unamortized tax OID created in the exchange. The court distinguished the case before it from transactions in which creditors initially fund a loan or bond indenture at a discount to the

¹ *In re Residential Capital (ResCap)*, Case No. 12-12020 (MG), slip op. at p. 53 (Bankr. S.D.N.Y. 2013).

² 11 U.S.C. § 502(b)(2).

³ *In re Chateaugay Corp.*, 961 F.2d 378 (2d Cir. 1992).

face amount, in which unamortized OID would not be included in a creditor's claim amount. In contrast, exchanges like the one before the court do not change the character of the underlying debt or discharge it, but only reaffirm and modify it. As such, the policy arguments for disallowing OID generated at a debt's original cash issuance are not applicable. The court also found significant that its ruling would encourage creditors to negotiate with distressed borrowers in the hopes of restructuring their debt and potentially avoiding bankruptcy filings.⁴ The net effect of the *Chateaugay* ruling was to treat tax OID arising from face value exchanges differently than tax OID arising from original cash issuances. For face value exchanges, any related OID created by the transaction for tax purposes will be included in the creditor's claim in a bankruptcy proceeding.

While the case law in this area is limited, *Chateaugay* has been cited favorably both for its formulation of OID and its discussion of OID arising from different transactions.⁵ Additionally, the Fifth Circuit adopted *Chateaugay's* approach to the treatment of face value exchange OID in *Matter of Pengo*.⁶

Although *Chateaugay* provided assurance for creditors who restructure their claims through face value exchanges, it and subsequent cases left open the question of whether the same treatment should be applied to fair value exchanges. The ResCap opinion examined and addressed this issue.

Case Background

On June 6, 2008, ResCap exchanged approximately \$6 billion face amount of its then-outstanding unsecured notes for approximately \$4 billion face amount of Junior Secured Notes ("JSNs") and \$500 million in cash. Based on the average trading price at issuance of the JSNs of \$613.75 for each \$1,000 face amount JSN, the JSNs were issued with 38.625% OID for tax purposes, or aggregate OID of \$1.549 billion, which was amortized over the life of the JSNs. Although the parties disputed the exact figure, the existence of between \$377 and \$386 million of unamortized OID at the time of the bankruptcy was not disputed.

ResCap and the Official Committee of Unsecured Creditors ("**Plaintiffs**") asked the bankruptcy court to disallow that portion of the JSN claim that constituted unamortized OID. The Plaintiffs argued that this amount should be disallowed as unmatured interest in bankruptcy. The successor indenture trustee ("**Defendant**") argued that *Chateaugay's* rejection of recognition of OID for bankruptcy purposes should be extended to fair value, as well as face value, exchanges.⁷

Analysis of Fair Value Exchange OID in Bankruptcy Proceedings

Judge Glenn found *Chateaugay* to be controlling and did not find any reason to distinguish between fair value and face value exchanges with respect to the treatment of OID in bankruptcy. In coming to this conclusion, Judge Glenn considered several factors.

First, Judge Glenn was convinced by the strong policy considerations that support the inclusion of OID related to fair value exchanges in the creditors' claim amount for bankruptcy purposes. The court reasoned that discounting claims arising from exchange offers below the reduced claim amount that the creditors have already agreed to is at odds with the strong bankruptcy policy of favoring and promoting

⁴ *Id.* at 383 (discussing Congress's intent to encourage parties to negotiate with distressed entities and minimize bankruptcy filings).

⁵ See, e.g., *In re Mt. Rushmore Hotel Corp.*, 146 B.R. 33, 36-37 (Bankr.D.Kan. 1992) (discussing *Chateaugay's* analysis of OID and finding that market discounts on purchases of bonds do not give rise to OID).

⁶ *Matter of Pengo Indus. Inc.*, 962 F.2d 543 (5th Cir. 1992) (holding that face value exchanges do not create OID for bankruptcy purposes, but declining to evaluate fair value exchanges).

⁷ *ResCap*, Case No. 12-12020 (MG), slip op. at p. 38 (Bankr. S.D.N.Y. 2013).

“speedy, inexpensive, negotiated resolution of disputes.”⁸ If fair value exchange OID were to be disallowed, lenders would be less willing to negotiate with distressed borrowers, and this could in turn lead to an increase in bankruptcy filings.

Second, Judge Glenn was not persuaded by the Plaintiffs’ arguments that fair value exchanges differ from face value exchanges in any relevant respect. In coming to this conclusion the court analyzed the circumstances surrounding the adoption of section 502(b)(2) and the nature of the exchanges. At the time of the enactment of section 502(b)(2) in 1978, debt-for-debt exchanges did not give rise to additional OID under the tax code. It was not until the Internal Revenue Code was amended in 1990 that distressed face and fair value exchanges both began to create OID for tax purposes. Following that change, *Chateaugay* held that face value exchanges do not create disallowable unmatured interest, notwithstanding the fact that they create OID under the tax code. Judge Glenn found no basis for distinguishing between OID generated by face and fair value exchanges. He gave great weight to the fact that companies consider largely the same factors when considering whether to engage in either a face or fair value exchange, a fact conceded by Plaintiff’s expert witness. Judge Glenn was also not persuaded by the Plaintiffs’ equity argument that the fact that the JSNs became secured with collateral through the exchange sufficiently distinguished this fair value exchange from *Chateaugay*, as that modification could have been implemented in a face value exchange as well.

Finally, the court was not persuaded by the Plaintiffs’ argument that the plain meaning of 502(b)(2) should prevail over policy arguments to the contrary, finding that the lack of a definition of “unmatured interest” in 502(b)(2) made the application of the plain language rule debatable. Instead, Judge Glenn adopted a broad view that whether a transaction “created disallowable OID should not depend on if the noteholders or the debtors got a ‘good deal’ in bankruptcy”⁹ and found that adoption of Plaintiff’s rule would likely create confusion and complications in the marketplace.

⁸ *ResCap*, Case No. 12-12020 (MG), at 54.

⁹ *ResCap*, Case No. 12-12020 (MG), at 58.

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