November 20, 2013

SDNY Bankruptcy Court Holds That a Fair Value Debt-for-Debt Exchange Does Not Create Disallowable OID

On the eve of confirmation of the chapter 11 plan of Residential Capital, LLC ("ResCap," and together with its affiliated debtors, the "Debtors"), the Bankruptcy Court for the Southern District of New York issued a 117-page opinion addressing, among other things, a discrete, but significant, issue for bankruptcy practitioners and bondholders alike—whether unamortized original issue discount ("OID") generated by a *fair value* debt-for-debt exchange constitutes disallowable "unmatured interest" under the Bankruptcy Code.[1] Relying on the rationale from Second Circuit precedent, Bankruptcy Judge Glenn held that while a fair value debt-for-debt exchange may generate OID for tax purposes, it does not create disallowable unmatured interest under the Bankruptcy Code.

While this Client Alert focuses on Judge Glenn's ruling with respect to the OID issue, his decision addressed numerous other issues, one of which merits specific mention—whether a secured creditor with liens on property held by multiple debtors may aggregate the value of the collateral across debtor entities for purposes of establishing that it is oversecured and, thus, entitled to postpetition interest under section 506(b) of the Bankruptcy Code. The Court held that aggregation is permissible, rejecting the Debtors' argument that a secured creditor must be oversecured with respect to a single debtor entity to receive postpetition interest under section 506(b).[2] The Court reasoned that the Debtors' view, if accepted, would (i) lead lenders to demand that collateral be held at a single entity and impose restrictions on collateral transfers within a borrower's corporate family, and (ii) nullify section 506(b) in multi-debtor cases where a secured creditor is not oversecured with respect to a single debtor entity but is vastly so when the value of the collateral held by all those liable for the debt is aggregated.[3]

ResCap is also noteworthy for its analysis of the alleged diminution in value of the collateral of the junior secured noteholders; only a handful of decisions have attempted to measure the diminution of value of collateral. The parties agreed that the diminution in value should be measured by the difference between the value of collateral at the effective date and the value at the petition date.[4] Because the effective date

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[1] *Official Comm. of Unsecured Creditors* v. *UMB Bank, N.A. (In re Residential Capital, LLC)*, Case No. 12-12020 (Bankr. S.D.N.Y. Nov. 15, 2013).

[2] *Residential Capital* at 72-80.

[3] *Id.* at 79-80.

[4] *Id.* at 60.

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value of the collateral was largely not in dispute, much of the testimony at trial related to the petition date value of the collateral (which Judge Glenn held, in this case, should equal the fair market value of the collateral in the Debtors' hands).[5] Judge Glenn found that the defendants did not provide a credible valuation of their collateral as of the petition date and, accordingly, failed to carry their burden of proving a diminution in the value of their collateral.[6] His decision confirms the importance of fact-specific expert testimony in valuation disputes.

Treatment of OID in Bankruptcy:

OID is a form of deferred interest that arises when a bond is issued at a discount to its face value. The discount (the difference between the bond's face amount and the proceeds received by the issuer) is amortized, for accounting and tax purposes, over the life of the bond, with the face value payable to the bondholder at maturity. Thus, when the face amount of the bond becomes payable at maturity, the lender receives a return on capital, plus interest.

In bankruptcy, claim allowance issues sometimes arise in connection with the treatment of unamortized OID. Section 502(b) of the Bankruptcy Code provides that a claim generally is deemed allowed except to the extent that, among other things, such claim is for "unmatured interest."[7] While the Bankruptcy Code fails to define "unmatured interest," the legislative history makes clear that it is meant to include "any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy."[8]

Suppose then that a corporation issues a bond with a face value of $1,000 for an issue price of $900. The OID is $100. If the corporation files for bankruptcy protection before the bond's maturity, the bondholder would have a claim for $900 together with any accrued interest (amortized OID) through the filing date. However, if the lender's claim is unsecured (including if it is undersecured), section 502(b) of the Bankruptcy Code requires disallowance of any interest that the lender would have earned after the commencement of the case.[9]

Though it is generally accepted that a creditor cannot assert a claim for unamortized OID on a plain-vanilla discounted bond, the treatment of a claim for unamortized OID generated in a debt-for-debt exchange is less clear. In *In re Chateaugay*, the United States Court of Appeals for the Second Circuit

[5] *Id.* at 67-68.

[6] *Id.* at 68-71.

[7] 11 U.S.C. § 502(b)(2).

[8] H.R. Rep. No. 95-595, at 352-53 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6308-09.

[9] *Id.*; *accord In re Solutia*, 379 B.R. 473, 486 (Bankr. S.D.N.Y. 2007).

held that a *face value* debt-for-debt exchange offered as part of a consensual workout did not generate any new OID that is disallowable under section 502(b).[10] A distressed face value exchange may generate taxable OID because the face amount of the new debt exceeds the consideration delivered to the issuer (*i.e.*, the fair market value of the old debt). In a policy-driven decision, the Second Circuit reasoned that disallowing OID generated in a face value exchange would create a disincentive for creditors to cooperate in consensual out-of-court workouts and lead to more chapter 11 filings.[11] The Court noted that disallowing such OID would also result in a windfall both to holdouts who refuse to work with struggling issuers and to issuers who file for bankruptcy protection after completing an exchange.[12] The Second Circuit expressly left open whether its ruling should extend to OID generated by a *fair market value* debt-for-debt exchange.[13] Judge Glenn's decision in *ResCap* directly addresses this issue.

Background of the Proceedings:

In 2008, approximately four years before the filing of the Debtors' chapter 11 cases, ResCap completed a fair value debt-for-debt exchange in which it offered to exchange its then-outstanding unsecured notes for junior-lien notes in a reduced principal amount (*i.e.*, to exchange $1,000 face amount of its old notes for $800 face amount of junior secured notes). The transaction resulted in ResCap exchanging approximately $6 billion of old notes for approximately $4 billion of junior secured notes and $500 million in cash. As an economic matter, the fair value debt-for-debt exchange created approximately $1.55 billion of OID which amortized over the life of the new junior secured notes.

In February 2013, the Debtors and their Official Committee of Unsecured Creditors brought an adversary proceeding seeking, among other relief, to disallow as "unmatured interest" the unamortized OID generated by the 2008 exchange. After denying a motion to dismiss the disallowance claim, Judge Glenn conducted a six-day trial at which the plaintiffs' expert suggested that economic incentives built into the exchange (*i.e.*, yield, security and seniority) made it attractive irrespective of the treatment of the OID in

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10 *In re Chateaugay Corp.*, 961 F.2d 378, 382-83 (2d Cir. 1992). A face value exchange is an exchange of existing debt for new debt of equal face value but with modified terms and conditions. Such an exchange does not reduce the borrower's overall debt obligations.

11 *Id.* at 382 ("We must consider the ramifications of a rule that places a creditor in the position of choosing whether to cooperate with a struggling debtor, when such cooperation might make the creditor's claims in the event of bankruptcy smaller than they would have been had the creditor refused to cooperate.").

12 *Id.*

13 *Id.* A fair market value exchange is an exchange of existing debt for new debt with a reduced principal amount, determined by the market value of the old debt. Unlike a face value exchange, a fair value exchange offers the issuer the advantage of reducing its debt obligations.

bankruptcy.[14] The defendants' expert noted that the low participation rate for the exchange showed that the market did not place much value on such incentives and stressed that disallowing OID generated by fair value exchanges would lead to more bankruptcy filings and discourage out-of-court workouts.[15] Notably, the experts for both sides testified that there is little difference between a face value exchange and a fair value exchange,[16] acknowledging that, under *Chateaugay*, if the new notes had been issued at the full face value of the old notes but retained all of the enhancements offered in the exchange, no disallowable OID would have been generated.[17]

Analysis:

The Bankruptcy Court concluded that the reasoning of *Chateaugay* dictates that unamortized OID generated by a fair value exchange should not be disallowed. The Court reasoned that no "meaningful basis" exists for distinguishing between face value and fair value exchanges and, thus, the same rule on disallowance of OID should apply in both instances.[18] The evidence presented at trial indicated that face value and fair market exchanges are "virtually identical."[19] Indeed, the plaintiffs' own expert had acknowledged that nearly all of the features that companies consider in connection with an exchange offer (*e.g.*, granting additional security, offering additional interest or extending maturity) exist in both face value and fair value exchanges and that distinguishing between the two is "somewhat arbitrary."[20]

The Court concluded that "no commercial or business reason, or valid theory of corporate finance, [exists] to justify treating claims generated by face value and fair value exchanges differently in bankruptcy."[21] The Court, like the Second Circuit in *Chateaugay*, found that the exchange did not create disallowable

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14 *In re Residential Capital* at 39.

15 *Id.* at 40.

16 *Id.*

17 *Id.* at 41.

18 *Id.* at 55, 57.

19 *Id.* at 57-58.

20 *Id.*

21 *Id.* at 58.

unmatured interest for purposes of the Bankruptcy Code even though it may have generated OID for tax purposes.[22]

The Court rejected the assertion that disallowing the OID in this particular case was consistent with the "plain language" of section 502(b)(2). The plaintiffs argued that applying the plain meaning would not lead to an absurd result because the noteholders that participated in the exchange would receive a greater recovery than those that did not. The Court was not persuaded, noting that its rules should provide "predictability" and avoid "confusion in the market."[23] To adjudicate the allowance of a noteholder's OID claim based on a noteholder's bankruptcy recovery would "likely complicate a financially distressed company's attempts to avoid bankruptcy with the cooperation of its creditors."[24]

Conclusion:

ResCap should give lenders comfort that, at least in the Southern District of New York, unamortized OID generated by debt-for-debt exchanges (whether face value or fair value) in connection with prepetition consensual workouts is not subject to disallowance as unmatured interest. Whether courts outside of the Southern District of New York will follow *ResCap* remains to be seen.

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22 *Id.* at 56. The Court also noted that "[a]t the time that Congress passed section 502(b)(2), debt-for-debt exchanges did not create OID for tax purposes." *Id.* at 55 (citation omitted). The Tax Code was amended in 1990 to provide that distressed face and fair value exchanges generated taxable OID. *Id.*

23 *Id.* at 58.

24 *Id.*

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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