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Original Issue Discount in a Fair Market Value Exchange Is an Allowable Claim in Bankruptcy

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May 20, 2014 - Companies struggling to address liquidity problems are often attracted to debt-for-debt exchanges because such exchanges accomplish many of the same purposes as refinancing without requiring upfront cash payments, except to cover transaction costs and professional fees. By restructuring debt obligations, a financially distressed company may avoid default and escape bankruptcy. Partaking in a debt exchange is advantageous for creditors because, among other things, the new debt is frequently more senior in a company's capital structure than the existing debt.

To date, however, it has been unclear whether the unamortized interest – *i.e.* original issue discount (“OID”) – generated by these exchanges would be an allowable claim in bankruptcy. A recent decision of the U.S. Bankruptcy Court for the Southern District of New York answered this question in the affirmative in *Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (In Re Residential Capital, LLC)*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013), finding that original issue discount can serve as the basis of a valid claim.

Face Value Exchange v. Fair Market Value Exchange

There are two types of debt-for-debt exchanges: face value and fair market value. In a face value exchange, a comparatively healthy organization with liquidity problems exchanges old debt for newly issued debt to obtain short-term relief while remaining fully accountable for the original amount of funds borrowed. In a fair market value exchange, an issuer in severe financial distress seeks to reduce its overall debt obligations by exchanging an existing debt for a new debt with a reduced principal amount that is determined by the market value at which the old debt is trading.

The amount of interest creditors receive back when the debt in either exchange matures is OID. OID is defined by the Internal Revenue Code (the “Tax Code”) as the “excess (if any) of the stated redemption price at maturity over the issue price.” 26 U.S.C. § 1273. It further describes “stated redemption price at maturity” as “the amount

fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and payable unconditionally at fixed periodic intervals of one year or less during the entire term of the debt instrument)." *Id.* Usually the interest in a debt-for-debt exchange is paid out all at once when the debt matures but, for tax or accounting purposes, the interest is accounted for as if it were paid out over the life of the debt. Thus, under the Tax Code, for purposes of determining taxable income, a debt-for-debt exchange generates new OID.

Because section 502(b)(2) of the Bankruptcy Code allows a bankruptcy claim except to the extent such a claim is for "unmatured interest," it was unclear how unaccrued OID would be treated in the bankruptcy context. 11 U.S.C. § 502(b)(2). With respect to face value exchanges, the Second Circuit has held that "OID on the new debt consists only of the discount carried over from the old debt, that is, the unamortized OID remaining on the old debt at the time of the exchange." *LTV Corp. v. Valley Fid. Bank & Trust Co. (In re Chateaugay Corp.)*, 961 F.2d 378, 383 (2d Cir. 1992). As such, the *In re Chateaugay* court held that OID in a face value debt exchange was not unamatured interest and thus was an allowable claim in bankruptcy. The Second Circuit reasoned that its decision comports with the legislative intent of encouraging debtors to avoid bankruptcy by cooperating with creditors and, in doing so, took into account the "strong bankruptcy policy in favor of the speedy, inexpensive, negotiated resolution of disputes, that is an out-of-court or common law composition." *Id.* at 382.

Left unanswered by the Second Circuit was whether the same logic applies to OID generated in a fair market value debt exchange, which was resolved in *In re Residential Capital LLC*.

In re Residential Capital LLC

On May 5, 2008, Residential Capital, LLC ("ResCap") offered to exchange its prepetition debt of \$6 billion in unsecured notes for about \$4 billion in new junior secured notes, and \$500 million in cash. Because the issue price of the junior secured notes was established based on the approximated market value of the old notes, this was considered a fair market value exchange. The official committee of unsecured creditors and ResCap sought a determination from the bankruptcy court that unaccrued OID in this fair market value debt exchange, totaling about \$377 million, was not an allowable claim because it was "unmatured interest" under the Bankruptcy Code.

With the *Chateaugay* decision as guidance, the court determined that OID in a fair market value exchange was not disallowed by Section 502(b)(2). He determined from the testimony of both the plaintiffs' and defendants' experts at trial that there was no basis for distinguishing OID generated by fair value exchanges from OID generated by face value exchanges. Both "fair and face value exchanges offer companies the opportunity to restructure out-of-court, avoiding the time and costs – both direct and indirect – of a bankruptcy proceeding." *In re Residential Capital, LLC*, 501 B.R. at 578-79.

The court noted that Section 502(b)(2) was passed at a time when debt-for-debt exchanges did not create OID for tax purposes. It was only after the 1990 amendments to the Tax Code that both distressed face value exchanges and fair value exchanges created taxable OID. He further noted that the both the Second Circuit and the Fifth Circuit^[1] have found that, notwithstanding the Tax Code, face value exchanges do not create disallowable unamatured interest. "The tax treatment of debt-for-debt exchanges derives from the tax laws' focus on realization events, and suggests that an exchange offer may represent a sensible time to tax the parties. The same reasoning simply does not apply in the bankruptcy context." *Id.* at 587.

The court found that all the features that companies consider in connection with a debt-for-debt exchange can be used in either face value or fair value exchanges, including: granting of security in the issuer's collateral; interest rate; maturity date; payment priorities; affiliate guarantees; other lending covenants; redemption features; adding or removing a sinking fund or conversion feature; and offering stock with the new debt. The court thus concluded 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” and he held that the junior secured noteholders claim was not reduced by the unaccrued OID. *Id.* at 588.

Practical Implications

Notably, the court placed greater weight on the fact that both types of debt exchanges offer distressed entities the opportunity to restructure out-of-court. Both sides experts acknowledged that if the creditors knew that a portion of the OID created in a fair market value exchange would be disallowed, distressed companies would need to provide better inducements for participation, and it would likely lead to more bankruptcy filings as opposed to out-of-court workouts. Such a result would frustrate the strong bankruptcy policy favoring speedy, inexpensive, negotiated resolution of disputes.

By finding that OID created in a fair market exchange is an allowable claim in bankruptcy, the ruling in *In re Residential Capital LLC* has reduced one uncertainty in the distressed debt market which should encourage highly-leveraged companies and their creditors to restructure distressed debt in an exchange regardless of whether it is a fair market or face value exchange.

Footnotes

[1] *Texas Commerce Bank, N.A. v. Licht (In re Pengo Indus., Inc.)*, 962 F.2d 543 (5th Cir. 1992).

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