Recent ResCap Decision Holds That Fair Market Value Note Exchange Does Not Create Original Issue Discount for Bankruptcy Claims Purposes

On November 15, 2013, the United States Bankruptcy Court for the Southern District of New York (Glenn, J.) issued a lengthy decision[1] in the Chapter 11 case of Residential Capital, LLC ("ResCap"). An important holding contained in this decision is that the bankruptcy claims of holders of notes issued with original issue discount (or OID) for tax and accounting purposes in a "fair value" exchange (an exchange for notes with a lower face amount) need not be reduced by any unaccreted OID.[2]

ResCap was one of the largest originators and servicers of residential mortgage loans. ResCap had a complicated capital structure, and among billions of dollars of funded debt, it had more than $2 billion of 9.625% Junior Secured Notes (the "JSNs") outstanding from a debt-for-debt exchange completed in 2008. In the exchange, ResCap swapped more than $6 billion of various series of outstanding unsecured notes for $862 million in cash and JSNs in a reduced face amount (80%), albeit with more attractive terms, including being secured by collateral and being structurally senior. The value of the JSNs, determined by the clearing price in a modified Dutch auction of the JSNs to enable a cash-out option for existing holders, was less than their face amount ($650 per $1,000), creating substantial OID. Approximately 63% of the outstanding old notes were exchanged for JSNs.[3]

As of the time of the bankruptcy filing, the JSNs had approximately $370 million in unaccreted OID, and various parties argued that this OID should not be allowed as part of the JSNs' claims, but rather should be treated as "unmatured interest", which would be disallowed under Bankruptcy Code § 502(b)(2). The JSNs countered that the exchange should not create disallowable OID for bankruptcy claims purposes under *LTV Corp. v. Valley Fidelity Bank & Trust Co. (In re Chateauguay)*, wherein the court held that a "face value" exchange (an exchange for notes with the same face amount) did not create new disallowable OID, so the full face amount was potentially recoverable in bankruptcy.[4] The face value exchange in *Chateauguay* was technically distinguishable from the ResCap fair value exchange at issue, and the court heard extensive expert testimony on the underlying contexts and strategies in which both types of exchanges are utilized in corporate restructurings.[5]

First, the court reviewed the legislative history of section 502(b)(2) and concluded that there was no basis for distinguishing fair value exchange OID from face value exchange OID for bankruptcy purposes. Then, it noted that *Chateauguay* was based on the Bankruptcy Code's policy of promoting cooperative out-of-court restructuring efforts, including consensual exchange offers, and attempting to avoid costly and protracted bankruptcy cases, and that such rationale applied equally to both types of exchanges. For these reasons, the court concluded that the unaccreted OID on the JSNs should not be disallowed as unmatured interest.[6]

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1 *Official Comm. of Unsecured Creditors v. UMB Bank, N.A., and Wells Fargo Bank, N.A. (In re Residential Capital, LLC, et al.)*, 2013 Bankr. LEXIS 4844 (Bankr. S.D.N.Y. Nov. 15, 2013). All cites are to the court's written opinion available on PACER or at http://www.kccllc.net/rescap.

2 *See id.*, at 53-59.

3 *See id.*, at 37-41.

4 961 F. 2d 378 (2d. Cir. 1992). Another Court of Appeals came to a similar conclusion in *In re Pengo Industries, Inc.*, 962 F.2d 543, 547 (5th Cir. Tex. 1992).

5 *See Residential Capital*, at 37-41; 53-59.

6 *See id.*, at 56-59.

Although not binding in other Circuits or even in other courts in the Southern District of New York, this ruling, which was anticipated by many practitioners, should provide lenders and investors with additional comfort that participating in a fair value or similar exchange that involves a reduction in face amount of claims should not result in an unintended further reduction of their claims in bankruptcy. As such, this decision should continue to encourage overleveraged companies and their lenders to seek to reduce debt, where appropriate, in a rational manner.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Joel H. Levitin at 212.701.3770 or jlevitin@cahill.com or Richard A. Stieglitz Jr. at 212.701.3393 or rstieglitz@cahill.com.

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