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FACE VALUE EXCHANGES, ORIGINAL ISSUE DISCOUNT, AND ELIMINATION OF THE "LTV RISK": IN RE CHATEAUGAY PAINTS A LEGAL LANDSCAPE

I. INTRODUCTION

In the aftermath of a financial era pervaded by overleveraging and the issuance of high yield "junk" bonds, a corporate debt default explosion has occurred. As a result, cost and time-efficient consensual workouts and negotiated out-of-court recapitalizations have become increasingly popular forms of financial restructuring in corporate efforts to avoid bankruptcy. Specifically, debt-for-debt exchange offers have

1. See Fred R. Bleakley, Emerging Risk: Big Banks May be Hit by Significant Losses from Buyout Loans, WALL ST. J., Jan. 4, 1991, at A1, A2 (estimating that as many as 120 companies, as compared to 90 in 1990, would default on bonds in 1991).

Throughout the 1980s, corporations increasingly utilized high interest rate bonds to meet their financing and acquisition needs. John P. Forde, Secured Loans Back Vintners Leveraged Buyout, AM. BANKER, July 3, 1987, at 3. The issuance of these bonds, labeled "junk" as a result of their "speculative" credit rating, grew from "about $1.5 billion in 1978 to $48 billion in 1986," at which time they constituted almost one quarter of all corporate bonds. Id.; see Andrew Albert, Fed Draws Fire for Expected Junk Bond Rule, AM. BANKER, Dec. 6, 1985, at 1 (defining junk bonds as "debt securities rated BB or lower by credit agencies"); Herb Greenberg, Business Insider, S.F. CHRON., Nov. 11, 1989, at B1 (junk bonds defined as "bonds rated at lower than investment grade"). Junk bonds fueled the use of debt-driven financial takeover techniques, known as leveraged buyouts, which offered corporations the benefits of reduced cash requirements during early debt years due to their deferred interest burdens and payment obligations. Leveraged Buyouts and Lenders' Risks, 21 SETON HALL L. REV. 918, 920-21 (1991). Between 1985 and 1989, the aggregate value of leveraged buyouts totaled $217 billion. Id. at 919. This figure represented "more [leveraged buyouts] than in the whole prior history of the world." Id.; see Marc S. Kirschner et al., Prepackaged Bankruptcy Plans: The Deterring Tool of the '90s in the Wake of Old and Tax Concerns, 21 SETON HALL L. REV. 643, 643 n. 1 (1991) (noting that public leveraged buyouts grew in number "from 99 to 251, while the aggregate value of these transactions grew from $3.1 billion in 1981 to more than $32.8 billion in 1989"). However, high yield and compounding requirements rendered the junk bonds and the leveraged buyouts they fostered "inherent time bombs," as companies were forced to expand rapidly in order to avoid defaulting on payment of the debt obligations. Leveraged Buyouts and Lenders' Risks, supra at 920-21. Many companies were unable to expand to satisfy these burdensome junk bond obligations, and were thus forced into default. Fred R. Bleakley, Bad Hangover: Many Firms Find Debt they Piled on in the 1980's is a Cruel Taskmaster, WALL ST. J., Oct. 9, 1990, at A1 (estimating $20 million in junk bond defaults for 1990 and $69 million between 1989 and 1992).

emerged as a prominent method of restructuring publicly traded debt. In this type of exchange, bondholders swap old debt for new debt possessing modified terms more favorable to the issuing corporation, such as adjusted interest rate and maturity date components. By restructuring the nature of its current debt obligations in this manner, a financially distressed corporation seeks to avoid default and escape bankruptcy. On the other hand, the bondholder accepts the terms of exchange in recognition of the current financial difficulties of the corporation, in the hope of increasing the probability of bond payment by allowing the corporation time to stabilize its financial status.

TIES REG. 159, 159 (Sept. 19, 1990) (noting that “increased concern in the financial marketplace regarding defaults, particularly those relating to leveraged buyouts, has led to a greater emphasis on developing effective and cost-efficient ways of restructuring troubled companies”). According to Weingarten, a financially burdened company “typically has two basic options to consider: bankruptcy or a consensual non-bankruptcy restructuring.” Further, because consensual out-of-court restructurings are “sometimes more efficient than bankruptcy, a financially troubled debtor normally should attempt to reach a voluntary accommodation with its creditors before seeking protection under the Federal Bankruptcy Code.”

3. See Herz & Abahoonie, supra note 2, at 13 (stating that “[d]ebt restructuring is nothing short of a radical reworking of a firm’s capital structure to relieve the strain of interest and principal payments”). For a further discussion of debt-for-debt exchange offers, see infra notes 29-36 and accompanying text. Exchange offers are “often the first strategy employed by a company facing an interest payment default on its public debt.” Richard L. Epling, Exchange Offers, Defaults, and Insolvency: A Short Primer, 8 BANKR. DEV. J. 15, 17 (1991). RELATIVELY healthy companies, saddled with debt obligations that strip necessary cash flow, undertake exchange offers to avoid bankruptcy filings. According to Epling, junk bonds possessing high yield interest rates and compounding payment terms are “likely to cause the exchange offer and its bankruptcy consequences to become ubiquitous in the 1990s.”

4. See Kirschner et al., supra note 1, at 645 (recognizing that “[i]n an exchange offer, creditors swap existing debt instruments for substitute debt instruments; the restructured (or substitute) debt typically contains different interest or coupon rates, maturity dates, security and/or financial covenants”).

5. Financially distressed corporations employ debt exchanges to avoid the “uncertainties and daunting transaction costs of bankruptcy.” In re Chateaugay, 961 F.2d 378, 381 (2d Cir. 1992). Indeed, the costs and rigors of a consensual non-bankruptcy restructuring typically pale in comparison to the transaction costs of a lengthy bankruptcy case, which commonly “remains pending for a minimum of two to three years.” Weingarten, supra note 2, at 159 n.2. Bankruptcy filing is highly cost-ineffective, predominantly because the debtor corporation is held responsible for the payment of professional fees and expenses. Additionally, even if successfully reorganized under Chapter 11 of the Federal Bankruptcy Code, a bankrupt corporation may be unable to overcome the stigma of bankruptcy. Kirschner et al., supra note 1, at 645 n.9. Moreover, corporate management faces the risk of removal by a court appointed trustee during the bankruptcy proceeding. Through a debt for debt exchange offer, a company can solve short-term liquidity problems and alleviate financial strain by reducing or deferring interest payments owed to bondholders while avoiding these perils of bankruptcy filing.

6. Chateaugay, 961 F.2d at 381. The bondholder, in accepting the plan and the proposed terms of exchange, recognizes the current financial difficulties of
If these debt restructuring efforts prove unsuccessful, a debtor corporation may subsequently file for bankruptcy for protection from bondholder claims. In such a case, the holders of the new modified debt instruments received in the exchange offer will expect to have claims in bankruptcy for the full face amount of their new debt. However, in In re Chateaugay, the United States Bankruptcy Court for the Southern District of New York held that these bankruptcy claims are limited to the fair market value of the old debt on the date of the exchange offer instead of the face amount of the new debt received. The danger of this limited recovery in bankruptcy following bondholder participation in a consensual corporate restructuring plan is termed the "LTV risk." The corporation and hopes to increase the likelihood of bond payment by allowing the financially strained corporation time to recover. Id.

7. Id. at 380.

8. See John C. Coffee, Jr. & William A. Klein, Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations, 58 U. Chi. L. Rev. 1207, 1248 (1991) (noting that "prepackaged bankruptcy" avoids risk that valid bankruptcy claims will only be in amount of fair market value of securities surrendered on the date of the exchange, rather than the face amount of new securities).


10. Chateaugay, 109 B.R. at 51. For a further discussion of Chateaugay, see infra notes 37-58 and accompanying text.

11. See Coffee & Klein, supra note 8 at 1248. LTV risk is the danger that on a subsequent bankruptcy of the debtor, the holder of the new securities received in an exchange offer will be deemed to have a valid bankruptcy claim only in the amount of the fair market value of the securities surrendered on the date of the exchange, rather than the face amount of the new securities.

Id. This danger was termed the "LTV risk" because the Chateaugay Corporation party to the case was a subsidiary of the LTV Corporation, a steel company and manufacturer of industrial and defense products. Chateaugay, 961 F.2d at 379.

LTV risk proscribes recovery of interest earnings unmatured as a result of bankruptcy. Chateaugay, 109 B.R. at 54-57. In essence, the risk generates original issue discount (OID) on new debt received in an exchange offer. Id. Original issue discount is defined as the "difference between the proceeds received by the issuer, before issuance expense, and the face amount of the debentures repayable by the issuer at maturity." Id. at 55. For a further discussion of original issue discount, see infra notes 21-28 and accompanying text. Courts have unanimously agreed that original issue discount, amortized over the life of the debt, is the functional equivalent of interest. Id. at 55. For a discussion of the treatment of original issue discount as interest for bankruptcy purposes, see infra notes 25-28 and accompanying text. Claims by creditors for unmatured interest are expressly disallowed under the Bankruptcy Code. Consequently, original issue discount unamortized at the time of Chapter 11 filing is not recoverable. Accordingly, creditors cooperating with a debtor company’s restructuring proposal are precluded from complete recovery of claims in bankruptcy which, prior to the exchange offer, were not subject to any limitations. See, e.g., Leveraged Buyouts and Lenders’ Risks, supra note 1, at 954. This commentator asserts that the Chateaugay bankruptcy court decision is “bad business” because the participating bondholder, while attempting to assist the financially troubled corporation, receives an “inferior economic deal” by virtue of his or her cooperation in the
LTV risk has proven to be a substantial disincentive for bondholders cooperating in out-of-court debt restructuring plans with debtor corporations and, accordingly, has received widespread criticism from commentators and practitioners alike.12

In In re Chateaugay,13 the United States Court of Appeals for the Second Circuit was presented with an opportunity to resolve the LTV risk controversy.14 Specifically, the Second Circuit addressed the issue of whether a face value debt-for-debt exchange generates an original issue discount, unallowable as part of a subsequent bankruptcy claim.15

restricting process. Id. The non-consenting debtholder, on the other hand, who refuses to participate in the restructuring plan, invariably receives a “better economic return” than the cooperating debtholder. Id. The tendency to reward a windfall to an uncooperative “holdout” creditor is, therefore, a direct result of the LTV risk. Chateaugay, 961 F.2d at 382. For a further discussion of the holdout problem and its effect upon corporate restructuring efforts, see infra notes 67-69 and accompanying text.

12. See Barbara Franklin, A Boost to Workouts; Ruling Encourages Out-of-Court Agreements, N.Y. L.J., Apr. 16, 1992, at 5 (noting that because of “potential to penalize creditors who exchanged their debt,” the LTV risk has become the subject of major controversy). In light of the LTV risk, bondholders may be very reluctant to participate in debt-for-debt exchange offers in corporate efforts to avoid bankruptcy. See Weingarten, supra note 2, at 160. According to Weingarten, bondholders have become increasingly organized and suspicious; holders of old debt commonly retain bankers and attorneys to evaluate the benefits of the debt restructuring proposal compared to potential for claims in bankruptcy after rejecting a restructuring plan. Id.; see Gary B. Wilcox & David M. Rievman, Restructuring Troubled Debt Under the New Debt Exchange Rules, 10 Va. Tax Rev. 665, 665 (1991) (recognizing that “[b]ondholders, who often have earned the least reward and borne the greatest risk for failed leveraged buyouts, have become increasingly reluctant to settle their claims outside of bankruptcy”); Sherry R. Sontag, It's Harder to Trade in Old Debts: After the LTV Case, Nat’l L.J., June 11, 1990, at 3 (stating that bondholder exchange offer rejections likely to increase following Chateaugay bankruptcy court ruling); see also Nicholas P. Saggeso et al., A Practitioner’s Guide to Exchange Offers and Consent Solicitations, 24 Loy. L.A. L. Rev. 527, 549 (1991) (commenting that LTV decision is “inappropriate and extremely unfair”); Phelan & Jernigan, OLD and the “LTV risk”: An Original Issue Disaster, Amer. Bankr. Inst. Newsletter, March-April 1990, at 6; Robin Goldwyn Blumenthal, Bondholders in Swap Offer Given Jolt by Bankruptcy Judge’s LTV Ruling, WALL ST. J., Jan. 31, 1990, at A3 (noting that LTV risk “hamper[ed] efforts of SCI Television Inc. to restructure $507 million in debt to avert threatened bankruptcy filing”).

13. 961 F.2d at 378 (2d Cir. 1992).

14. Chateaugay, 961 F.2d at 378. As the Chateaugay Corporation was a subsidiary of the LTV Corporation, a steel company and manufacturer of industrial and defense products, the risk was termed the “LTV risk.” Id. at 379. Because of its “potential to penalize creditors who exchanged their debt,” the LTV risk became the subject of bondholder controversy. Franklin, supra note 12, at 5. For a further discussion of the LTV risk, see supra notes 11-12 and accompanying text.

15. Chateaugay, 961 F.2d at 378. In May 1986, the LTV corporation proposed a debt restructuring plan that “offered to exchange $1000 face amount of New Notes and 15 shares of LTV common stock for each $1000 face amount of Old Debentures.” Id. at 380. The old debentures consisted of 131/4% sinking fund debentures with a maturity date of December 1, 2002. Id. at 379. In ex-
The Second Circuit reversed the decision of the bankruptcy court and held that no new original issue discount was generated on exchanged new debt instruments, thereby eliminating the "LTV risk." The court based this decision predominantly upon a strong interest in comporting with a settled bankruptcy policy to encourage, and not deter, creditor cooperation in consensual workouts.

This Note first examines original issue discount as unmatured interest and debt-for-debt exchanges as consensual workout devices, to provide a backdrop for analyzing the Second Circuit's decision in In re Chateaugay. This Note then discusses and evaluates the court's reasoning and the bankruptcy policy rationale underlying the outcome in Chateaugay. Finally, this Note considers the practical impact of the Sec-
ond Circuit's *Chateaugay* decision in neutralizing the LTV risk\(^\text{19}\) and concludes that *Chateaugay* will effectively encourage creditor cooperation in corporate debt restructuring plans.\(^\text{20}\)

II. **BACKGROUND**

A. **Original Issue Discount as Unmatured Interest**

Bonds issued at a price less than face value are considered to be issued at an original issue discount.\(^\text{21}\) Specifically, original issue discount amounts to the difference between the consideration received by the debt-issuing corporation and the face amount of the debt instrument.\(^\text{22}\) When the prevailing market rate of interest exceeds the stated interest rate on a debt instrument, a bond purchaser is compensated for the rate discrepancy through original issue discount, which essentially constitutes additional interest on the bond.\(^\text{23}\) Consequently, original issue discount and interest receive identical treatment under the Bankruptcy Code.\(^\text{24}\)

Section 502(b)(2) of the Bankruptcy Code defines the scope of permissible Chapter 11 bankruptcy creditor claims and provides that a

\(^{19}\) For a discussion of the practical impact of the Second Circuit's decision, see *infra* notes 74-101 and accompanying text.

\(^{20}\) For a discussion of the Second Circuit's decision as encouraging creditor cooperation in debt restructuring efforts, see *infra* notes 102-111 and accompanying text.

\(^{21}\) *Chateaugay*, 109 B.R. at 55.

\(^{22}\) Id.

\(^{23}\) Id. According to the bankruptcy court, "original issue discount is nothing more or less than additional interest paid on a particular debenture." *Id.* The difference between the price paid by the bondholder and the face amount of the bond is "intended to compensate the purchaser for buying a debenture with a stated interest rate below market levels." *Id.* For example, assume that, in 1990, ABC Corp. issues $1000 face amount debentures due in 1994 with an interest rate of 12%. The debentures are issued at $700 for each $1000 face amount based upon the market's estimation of the value of the issuer's credit and prevailing market interest rates. The original issue discount, the difference between the face amount and the actual issue price, is $300, which represents the imputed interest to be earned by the debentureholder over the life of the debenture. Kirschen et al., *supra* note 1, at 649-50; see *American Smelting & Ref. Co. v. United States*, 130 F.2d 883 (3d Cir. 1942). In *American Smelting*, the Third Circuit noted that "[o]rdinarily, bonds are issued at a discount because the promised rate of interest is, due to the condition of the prevailing market, too low to sell them at par." *American Smelting*, 130 F.2d at 885. Therefore, the "discount allowed is in the nature of additional interest which accrues over the life of the bond and is payable at the maturity of the principal obligation." *Id.*; see Frank J. Slagle, *Accounting for Interest: An Analysis of Original Issue Discount in the Sale of Property*, 32 S.D. L. REV. 1, 21 n.108 (1987) ("The amount of the discount represents compensation to the Lender for the use and forbearance of money, i.e., interest.").

\(^{24}\) For a discussion of Bankruptcy Code treatment of interest and original issue discount, see *infra* notes 25-28 and accompanying text.
claim is allowable "except to the extent that . . . such claim is for unmatured interest." While unmatured interest is not defined in the Bankruptcy Code, the legislative history of § 502(b)(2) clearly indicates that original issue discount constitutes unearned interest. Accordingly, courts have consistently recognized that original issue discount is within the scope of unmatured interest for bankruptcy and tax purposes. Therefore, to the extent that it is unamortized at the date of bankruptcy, original issue discount is not recoverable as part of a bankruptcy creditor claim.

B. Debt-for-Debt Exchanges

Exchange offers are the most commonly used non-bankruptcy, public debt restructuring device for corporations in financial distress. Exchange offers may take the form of either a market value or a face value

26. H.R. REP. No. 595, 95th Cong., 1st Sess. 352 (1977), reprinted in 1978 U.S.C.C.A.N. 6307, 6308. The relevant legislative history of § 502(b)(2) states that "[i]nterest disallowed under this paragraph includes post petition interest that is not yet due and payable, and 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." Id.
27. See United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965) (noting that "original issue discount serves the same function" as interest for tax purposes and is "simply compensation for the use or forbearance of money"); In re Public Serv. Co., 114 B.R. 800, 803 (Bankr. D.N.H. 1990) (stating that "[t]he word 'interest' in the statute is clearly sufficient to encompass the OID variation in the method of providing for and collecting what in economic fact is interest to be paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned"); In re Allegheny Int'l, Inc., 100 B.R. 247, 250 (Bankr. W.D. Pa. 1989) (holding that "original issue discount is unmatured interest, as that term is used in section 502(b)(2)"); see also In re Pengo Indus., Inc., 129 B.R. 104, 108 (Bankr. N.D. Tex. 1991) (recognizing that if OID arises out of an exchange of debt instruments, then subsequent claims in bankruptcy for the full face value of the debentures "include unmatured interest, which is not allowable under 11 U.S.C. § 502(b)(2) as part of a claim").
28. Public Serv. Co., 114 B.R. at 803. For accounting purposes, original issue discount is amortized over the life of the debt instrument. Kirschner et al., supra note 1, at 649. Therefore, if only one-third of a discount amount has been amortized at the time of bankruptcy, then two-thirds is disallowed and unrecoverable as part of a creditor claim under § 502(b)(2) of the Bankruptcy Code. Public Serv. Co., 114 B.R. at 803 (citing H.R. REP. No. 595, 95th Cong., 1st Sess. 352, 353 (1977), reprinted in 1978 U.S.C.C.A.N. 6308, 6308). This disallowed portion is considered unmatured or unamortized interest "not yet due and payable." Id. The rationale behind the Bankruptcy Code's exclusion of unmatured claims is that creditors should be prevented from "claiming disguised, unearned interest." Saggeso et al., supra note 12, at 550. "In other words, the rule protects the debtor and its other creditors from the assertion of claims for amounts in excess of the benefit actually conveyed to the debtor." Id.
29. Weingarten, supra note 2, at 161. In an exchange offer, the issuing company offers new debt or equity securities in exchange for old securities. Id. Exchange offers are the "most common non-bankruptcy technique used to restructure public debt securities." Id.
Both methods involve the swapping of “old” debt securities for “new” debt instruments and both contain positive and negative incentives designed to coax reluctant investors out of their holdout positions and to induce them to participate in the exchange. While the success of both face value and market value exchanges is ultimately measured by the number of debtholders who cooperate, the terms of the new debt instruments issued differ greatly depending upon which exchange method is implemented.

A face value exchange modifies the payment terms of the existing debt instrument, such as maturity date or interest rate, but holds the principal amount of the debt constant. This method of restructuring

30. Chateaugay, 961 F.2d at 381; see Weingarten, supra note 2, at 161; Kirschner et al., supra note 1, at 645-46.

31. Weingarten, supra note 2, at 161. “The positive incentives may include the offer of new securities that are expected to have a greater market value after the financial restructuring is completed than the old securities are expected to have if the restructuring is not completed.” Id. This potentially greater market value is the result of modifications to the existing debt obligations issued by the corporation. Id. For example, “a greater interest rate, a shorter maturity date, a senior or secured position, more restrictive covenants, or an increased equity position in the issuer” are examples of positive incentives that promise an increased market value. Id. In the exchange offer proposed by LTV, a shorter maturity date, senior status and fifteen shares of common stock (an increased equity position) were combined as positive incentives. Chateaugay, 961 F.2d at 379-80. “The negative incentives may include the risk of bankruptcy if the exchange is not effected, or the fact that non-exchange holders will own securities that are contractually junior to those held by the exchanging holders (and therefore potentially less valuable).” Weingarten, supra note 2, at 161. For a discussion of bankruptcy risk as a negative incentive, see supra note 5 and accompanying text.

32. Weingarten, supra note 2, at 162. The holdout problem is essentially the inability of debtor corporations to compel debtholder cooperation in exchange offers. Id. Debtholders will inevitably compare the incentives offered in the exchange to the bankruptcy alternative. Id. Unlike Chapter 11 bankruptcy reorganizations, in which all debtholders of a given class are bound to the accepted reorganization plan, exchange offers cannot force reluctant debtholders into accepting the proposed restructuring plan. Id. However, state law may provide an exception to this proposition. Id. at 162 n.20. For example, Delaware state law contains a provision whereby corporate certificates of incorporation are permitted to include “anti-holdout provisions.” DEL. CODE ANN. tit. 8, § 102(b)(2) (1991). Under this provision, a vote by “a majority in number representing three-fourths in value of the creditors or class of creditors, and/or of the stockholders or class of stockholders” may bind all debtholders, including holdouts, as well as the corporation, to the terms of the exchange offer. Id. Such a transaction requires court approval. Id.

33. Kirschner et al., supra note 1, at 645-46. In other words, a face value exchange “involves the substitution of new indebtedness for an existing debenture,” without any reduction in the corporation’s overall debt obligations. Chateaugay, 961 F.2d at 382. The exchange of old debentures for new notes holding shorter maturity dates at issue in which the principal amount of the debt instrument remained the same was a face value debt-for-debt exchange offer. See Kirschner et al., supra note 1, at 651 (noting that Chateaugay involved face value exchange).
allows financially troubled companies to solve short term liquidity problems by providing additional time in which to recover from financial difficulties. In contrast, market value exchanges swap old debt instruments for new ones possessing reduced principal amounts determined by the fair market value of the old debt. Thus, market value exchanges serve to actually reduce the overall liabilities of the troubled company rather than simply alter the character of the existing debt. Accordingly, the face value and market value exchange offer alternatives impact a debtor corporation's financial position quite differently. However, the impact of a corporation’s use of one of these alternatives upon creditor claims in a subsequent bankruptcy was an unsettled question until the Second Circuit's decision in Chateaugay.

C. In re Chateaugay

In In re Chateaugay, the United States Bankruptcy Court for the Southern District of New York faced an issue of ‘national first impression.’ The bankruptcy court confronted the question of whether, in a face value exchange, new original issue discount was generated from a consensual exchange of old debt for new debt. The court’s decision,

34. Kirschner et al., supra note 1, at 646. The issuing company remains fully liable for the principal amount of the original debt but is able, through the restructuring plan, to obtain financial relief in the form of deferred interest or modified payment terms. Id.; see Chateaugay, 961 F.2d at 382.

35. Kirschner et al., supra note 1, at 645-46; see Chateaugay, 961 F.2d at 381-82 (noting that because market value exchanges reduce corporation's overall debt obligations, they are usually “sought only by companies in severe financial distress”).

36. Kirschner et al., supra note 1, at 646. Consequently, the debtor corporation may have to offer additional consideration or incentives in order to encourage bondholders to participate in a fair market exchange. Id. at 646-47.

37. In re Pengo Indus., Inc., 962 F.2d 543, 547 (5th Cir. 1992).

38. Chateaugay, 109 B.R. at 56-57. The creation of new original issue discount was the primary issue focused upon by the Chateaugay bankruptcy court. Id. at 54-74. Nevertheless, the old debentures in Chateaugay held a face value of $125 million and were issued for proceeds amounting to only 88.67% of their face value. Chateaugay, 961 F.2d at 379-80. The old debentures were, therefore, issued at an original issue discount. Id. at 381. Both the bankruptcy court and the Second Circuit held that this original issue discount must be carried over to the new notes at the time of the face value debt-for-debt consensual exchange, and that it constituted unearned interest disallowed under § 502(b)(2). Id. at 383-84 (ruling 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”); see Chateaugay, 129 B.R. at 55 (noting that “unamortized original issue discount on [old] debentures is indeed unmatured interest which is not an allowable claim”). Because the Second Circuit rejected the notion that any new original issue discount was generated in the exchange, this carryover original issue discount was the only discount that the court held existed on the new notes. Chateaugay, 961 F.2d at 383-84.

In addition to the new original issue discount creation question, the bankruptcy court also discussed the following issues: (1) was Valley Fidelity the proper party in interest in the action; and (2) what is the proper method of cal-
that new original issue discount is generated from face value debt-for-debt exchanges, rested upon the 1989 decision of the United States Bankruptcy Court for the Western District of Pennsylvania in In re Allegheny International, Inc., § 1273(b) of the Internal Revenue Code, and language excerpted from the Offering Circular provided to bondholders in the LTV exchange offer. 39 An understanding of these authorities is essential to an effective analysis of the Chateaugay decision and an evaluation of its validity.

The first case to examine the issue of the creation of original issue discount in an exchange offer under § 502(b)(2) was In re Allegheny International, Inc. 40 After recognizing that original issue discount was disallowed in § 502(b)(2) claims as unmatured interest, the bankruptcy court held that original issue discount was generated from a stock-for-debt exchange. 41 Additionally, the Allegheny court rejected the Second Circuit's earlier position in In re Radio-Keith-Orpheum Corp., upon which the Chateaugay bondholders relied. 42 In Radio-Keith-Orpheum, the Second Circuit allowed claims in bankruptcy for the full face value of debentures that had been issued in an exchange prior to bankruptcy. 43 The Alle-
gheny court reasoned that the clear language of § 502(b)(2) and its legislative history were controlling and, accordingly, found Radio-Keith-Orpheum to hold only that face value claim allowance was permissible rather than mandatory. In rejecting Radio-Keith-Orpheum, the Allegheny court resolved the original issue discount question in a manner consistent with tax policy considerations as expressed in § 1273(b)(3) of the Internal Revenue Code.

The treatment of face value exchanges under the Internal Revenue Code results in a potential generation of original issue discount. Section 1273(b) of the Code, upon which the Chateaugay bankruptcy court relied, provides that if a debt instrument is exchanged for property holding the same principal amount and regularly traded on an established securities market, the issue price of the debt instrument shall be the fair market value of the exchanged property. For tax purposes, therefore, the swapping of new debt for old debt, even in the case of a face value exchange, generates original issue discount whenever the fair market value of the old debt falls below the face value of the new debt instrument. This tax treatment of an exchange is illustrated in Gulf.

44. Allegheny, 100 B.R. at 250-51.
45. See I.R.C. § 1273(b)(3) (1988) (stating that when debt instrument or property received is publicly traded, issue price of debt instrument equals fair market value of property received in exchange for instrument).
46. For a discussion of the relevant Internal Revenue Code provisions and the application of those provisions to restructuring transactions, see infra notes 47-53 and accompanying text.
47. I.R.C. § 1273(b)(3). The Chateaugay bankruptcy court referred to this Code provision to justify its finding that original issue discount was generated. Chateaugay, 109 B.R. at 55; see also Kirschner et al., supra note 1, at 654 (noting that the Chateaugay bankruptcy court “relied on § 1273(b) of the Internal Revenue Code to provide the basis for establishing that the issue price of one security issued in exchange for another having the same principal amount is the fair market value of the old security”); Wilcox & Rievman, supra note 12, at 669 n.28 (stating that Chateaugay “suggested that the financial and tax rules controlling the determination of original issue discount, including section 1273(b)(3), should be applicable for bankruptcy purposes”).
48. Chateaugay, 109 B.R. at 55. According to the Chateaugay bankruptcy court, the Internal Revenue Service has “detailed guidelines to force the issuer and purchaser to reflect the underlying economic substance of original issue discounts.” Id. Therefore, for tax purposes, a debenture issuance at a price less than the principal amount on the face of the debenture generates original issue discount. Id. As a result, in the case of a face value exchange, which by definition holds principal amounts constant in both old and new debt instruments, original issue discount arises, for tax purposes, whenever an old debt instrument possessing a market value less than principal is swapped. I.R.C. § 1273(b)(3).
Mobile & Ohio Railroad v. United States, 49 in which the Fifth Circuit determined that a voluntary exchange of preferred stock for new income debentures generated original issue discount, because the fair market value of the outstanding preferred stock was less than the stated face value of the new debentures. 50 Similarly, in Cities Service Co. v. United States, 51 the Second Circuit held that original issue discount arose from a debt-for-equity exchange, in which the face value of the new securities exceeded the market value of the old debt at the time of the exchange. 52

The Chateaugay bankruptcy court utilized the § 1273(b) tax principle illustrated in Gulf and Cities as a basis for reasoning that the “underlying economic substance” of the face value exchange between the LTV Cor-

49. 579 F.2d 892 (5th Cir. 1978).
50. Id. at 897-98. Prior to Gulf, the United States Supreme Court addressed the discount generation issue and determined that, for tax purposes, amortizable discount did not arise when the considerations exchanged, debt for equity, were of equal value. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 154, 152 (1974). In National Alfalfa, shareholders consensually exchanged $50 preferred shares for $50 debentures. Id. at 137-39. In determining whether debt discount arose from an exchange, the Court stated that the “relevant inquiry in each case must be whether the issuer-taxpayer has incurred, as a result of the transaction, some cost or expense of acquiring the use of capital.” Id. at 147. According to the Court, this “cost or expense” incurred by the issuing company constitutes original issue discount for the debtholder because the debtholder receives a new debt instrument with a face value principal amount exceeding the fair market value of the old security. Id. at 148.

In Gulf, the GM&O Corporation offered to swap one income debenture with a face amount of $100 in exchange for one share of outstanding preferred stock with a stated value of $100. Gulf, 579 F.2d at 893. The Fifth Circuit held that original issue discount had been generated despite the fact that the face value of the new debenture equaled the stated value of the preferred stock. Id. at 895-99.

The Gulf court refused to “read National Alfalfa as establishing an absolute ban on discount when a corporation exchanges its bonds for its own preferred stock.” Id. at 896. Specifically, the Fifth Circuit distinguished National Alfalfa on three separate grounds. Id. at 897. First, the Gulf court recognized that, unlike the National Alfalfa exchange, the original value received by the debtor corporation in Gulf for each share of preferred stock was less than the face amount of the new debenture. Id. Second, the court noted that the debtor corporation in Gulf had incurred a cost of borrowing, while the debtor corporation in National Alfalfa had experienced an “inconsequential” change in corporate structure. Id. at 898. Finally, and “perhaps most importantly,” the Gulf court emphasized that the Gulf exchange was a voluntary shareholder transaction, unlike the National Alfalfa exchange, which was mandated by an amendment to the debtor’s articles of incorporation. Id.

52. Id. at 1288. In Cities, the Second Circuit also distinguished National Alfalfa and held that the exchange of outstanding shares of preferred stock for new debentures generated a debt discount. Id. The Cities court reasoned that the debtor corporation incurred a cost when it replaced its existing obligations under the preferred stock with the new obligations, fixed at face value, of the debentures. Id. In addition, the Cities court recognized that the face amount of the new debentures greatly exceeded both the original consideration received for the preferred shares as well as the current stated value. Id.
poration and its debtholders constituted a discounted issuance. The court also identified language from the Offering Circular distributed to the holders of the old debt instruments in the LTV exchange as evidence of the voluntary nature of the transaction. Moreover, the Chateaugay court perceived the altered interest rates, maturity dates and sinking fund requirements of the new notes to be substantive economic modifications, rather than mere formal changes. These findings, in conjunction with a literal statutory interpretation of § 502 of the Bankruptcy Code, provided the basis for the Chateaugay bankruptcy court's holding. This decision, affirmed by the District Court for the Southern District of New York, created the LTV risk and substantially deterred the success of consensual workouts.

III. Analysis

A. Stay Out of Court

In In re Chateaugay, the Second Circuit examined the nature of face value exchanges and rejected the bankruptcy court's strict application of the Bankruptcy Code definition of original issue discount. The court

53. Id. at 57.

54. Id. at 56. The Offering Circular disclosed the potential consequences of the proposed exchange offer upon debtholders. Id. at 56. Specifically, the Circular noted that:

[i]n general, a note, bond or debenture represents a potential bankruptcy claim equal to its face amount, plus accrued and unpaid interest through the date of the commencement of the bankruptcy case, less unamortized original issue discount, if any . . . . To the extent that the Exchange Offers involve the issuance of New Notes at an original issue discount, exchanging holders may have a smaller bankruptcy claim immediately thereafter than at present. Id. (quoting Offering Circular dated May 1, 1986). For a further discussion of the impact of the offering circular and the voluntary nature of the LTV restructuring plan, see infra notes 91-92 and accompanying text.

55. Chateaugay, 109 B.R. at 56. The bankruptcy court rejected the argument that the LTV face value exchange was "merely a 'bookkeeping entry' that should not be accorded any economic or legal significance." Id.

56. Id. Specifically, in addressing whether original issue discount constitutes interest for Bankruptcy Code purposes, the Chateaugay bankruptcy court held that "semantics should not distort the rationale and purpose of the Code" and, therefore, "unamortized original issue discount on a note or debenture is indeed unmatured interest which is not an allowable claim under Code section 502(b)(2)." Id. at 55.

57. The United States District Court for the Southern District of New York adopted the reasoning of the bankruptcy court in its entirety. In re Chateaugay, 130 B.R. 403 (S.D.N.Y. 1991), aff'd in part and rev'd in part, 961 F.2d 378 (2d Cir. 1992). The district court concluded that the bankruptcy court "addressed the parties' positions and the various bases for opposition that the appellants raise in this Court, in much the same manner as this Court would." Id. at 405.

58. Chateaugay, 961 F.2d at 382. The Second Circuit stated that:

[t]he bankruptcy court's reasoning leaves us unpersuaded. While its application of the definition of OID to exchange offers may seem irrefutable at first glance, we believe the bankruptcy court's logic ignores the
scirtinized the detrimental effects of the LTV risk and adopted a workout-encouraging approach.\textsuperscript{59} Placing considerable emphasis upon bankruptcy policy considerations, the Second Circuit reversed the bankruptcy court’s decision and held that a face value debt-for-debt exchange fails to generate original issue discount on a bondholder’s new debt instrument.\textsuperscript{60}

The foremost consideration adhered to by the Second Circuit was an interest in promoting bankruptcy policy.\textsuperscript{61} Specifically, the court criticized the bankruptcy court’s decision as senseless, in light of the significant bankruptcy policy concerns favoring efficient and cost-effective negotiated workouts.\textsuperscript{62} Additionally, the Second Circuit pointed to Bankruptcy Code legislative history emphasizing that the Code was designed, in large measure, to promote and not hinder out-of-court workouts.\textsuperscript{63} Thus, the Second Circuit resolved the original issue dis-

\begin{itemize}
\item \textsuperscript{59} Id.
\item \textsuperscript{60} Id.
\item \textsuperscript{61} Id.
\item \textsuperscript{62} Id. Indeed, the overbearing costs and rigors associated with the bankruptcy process render full-blown bankruptcy litigation a last resort. See Weingarten, \textsuperscript{supra} note 2, at 159 n.2 (stating that bankruptcy transaction costs may significantly exceed the costs of consensual workouts and other non-bankruptcy restructuring plans).
\item \textsuperscript{63} Chateaugay, 961 F.2d at 382. The legislative history underlying the Bankruptcy Reform Act of 1978 emphasizes that the out-of-court reorganization procedure, “sometimes known as a common law composition,” is faster and less expensive than the bankruptcy alternative. H.R. REP. No. 595, 95th Cong., 1st Sess. 220 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6179-80. Further, noting the economic efficiency of reorganization as opposed to liquidation, the legislative history of the Act acknowledges that if a company can “extend or reduce its debts,” on its own, it can often avoid the bankruptcy process altogether. Id. Courts have consequently recognized that “Congress designed the Code, in large measure, to encourage workouts in the first instance, with refuge in bankruptcy as a last resort.” \textit{In re Colonial Ford}, Inc., 24 B.R. 1014, 1015 (Bankr. D. Utah 1982).
\item The \textit{Colonial Ford} bankruptcy court acknowledged the consensual workout as superior to bankruptcy for at least three reasons. Id. at 1016. First, workouts are less time-consuming and therefore avoid the delay and inflexibility of the bankruptcy process. Id. Second, the workout process is efficient because it “avoids the superstructure of reorganization: trustees, committees, and their professional representatives.” Id. Moreover, bankruptcy typically places difficult operating burdens upon the customer service, sales, credit, and accounts receivable components of the company. Id. Finally, workouts are “sensible” because they require “participation from all parties in interest, good faith, conciliation, and candor,” and avoid judicial resolution of a problem better suited to the involved and experienced parties. Id.; see \textit{In re Curlow Valley Assocs.}, 14 B.R. 506, 511 (Bankr. D. Utah 1981) (noting that, generally, insolvency problems are matters for extra-judicial resolution, properly calling for “business [and] not legal judgment”).
\end{itemize}
count question by embracing the legislative history and policy principles underlying the Bankruptcy Code and arrived at a decision that effectively averted the unfavorable effects of the LTV risk.64

In reversing the bankruptcy court’s decision, the Second Circuit specifically criticized the detrimental policy consequences of the bankruptcy court’s holding.65 Initially, the court noted that the bankruptcy court’s decision proved a substantial impediment to the restructuring process.66 With cooperation between creditor and debtor as an established bankruptcy goal, the Second Circuit recognized the potential danger of a decision that discouraged debtholder participation in the consensual workout process.67 Indeed, according to the Second Circuit, out-of-court restructuring efforts yielding unrecoverable unmatured interest would serve only to increase the number of debtholder abstentions and exacerbate the holdout problem.68 In addition, identifying windfalls bestowed upon both the bankrupt issuer and the uncooperative holdout, the court highlighted a severe inequity resulting from the bankruptcy court’s decision.69 While recognizing that such results may

64. Chateaugay, 961 F.2d at 384. The Fifth Circuit was also recently presented with the question of original issue discount generation in In re Pengo Indus., Inc., 962 F.2d 543, 548-49 (5th Cir. 1992). Subscribing to the logic of the Second Circuit, the Fifth Circuit similarly held that original issue discount was not generated in a face value debt-for-debt exchange. Id. In Pengo, a petroleum industry equipment manufacturer proposed an exchange offer to its debtholders in an effort to restructure its debt obligations. Id. at 544-45. Under the terms of the exchange, holders of old debentures with $1000 face amounts, 8.5% interest rates and 1995 maturity dates were entitled to two $500 face amount new debentures with 0% interest rates and 1991 maturity dates. Id. at 545. The Fifth Circuit noted that the Pengo debt restructuring plan, a face value exchange of old indebtedness for new indebtedness, was “like that in Chateaugay” and therefore failed to create any new original issue discount. Id. at 547. The Fifth Circuit noted, however, that the Pengo exchange differed from the Chateaugay exchange “in one respect.” Id. at 547 n.3. Specifically, the Fifth Circuit recognized that the Chateaugay old debentures, unlike the Pengo old debentures, were initially issued at a discount and therefore carried a discount at the time of the exchange. Id. For a discussion of the effects of the initially discounted Chateaugay old debentures, see supra note 38.

65. Chateaugay, 961 F.2d at 382.

66. Id.

67. Id.

68. Id. The bankruptcy court’s holding increased the number of uncooperative creditors more willing to holdout instead of to participate in a restructuring program, even though such a program would be potentially beneficial to both the company and creditor. Weingarten, supra note 2, at 163.

69. Chateaugay, 961 F.2d at 382. In effect, the Chateaugay bankruptcy court’s ruling penalized the cooperating bondholders. Sagesse et al., supra note 12, at 549. Creditors participating in the consensual workout had their bankruptcy claims “reduced to the fair market value of their extensions of credit prior to a bankruptcy filing” while other, uncooperative creditors “receive[d] a greater pro rata bankruptcy distribution than they otherwise would receive.” Id. at 549-50. The greater share awarded to an uncooperative (holdout) creditor amounts to a “better economic return” for the “fellow who just sits with the paper he originally had” and refuses to cooperate in a proposed workout.

Leveraged Buyouts and
prove a permissible consequence of a market value exchange, the Second Circuit concluded that the nature of LTV's face value exchange itself prohibited such a disparity. 70

In a final criticism of the bankruptcy court's reasoning, the Second Circuit held that face value exchanges merely modify existing debt obligations rather than alter the overall character of the debt. 71 Specifically, because principal amounts remain unaffected by the face value exchange process, the issuing company experiences no reduction in liability level. 72 Accordingly, the Second Circuit recognized that a finding of original issue discount would be "unsupportable," in so far as original issue discount effects a reduction of liabilities upon the bankrupt issuer when "no such reduction" exists on the issuer's balance sheet from the exchange. 73

Lenders' Risks, supra note 1, at 954. Discussing the impact of the Chateaugay bankruptcy court decision, commentators have recognized that:

[b]y revaluing only the face value exchangor’s claim downward while leaving the holdout's claim intact, the court creates a windfall for the non-exchanging holdout in a subsequent bankruptcy. The result also creates a windfall for the company by relieving its debt measured by the additional OID. Thus, Chateaugay gives creditors a disincentive to cooperate with a struggling debtor in a consensual workout and gives an artificial benefit to the debtor.

Kirschner et al., supra note 1, at 658. The bankruptcy court therefore treated cooperative debtholders "as paying little for the notes they received and also as buying notes issued just before the commencement of the bankruptcy, so that a significant proportion of their claims were for unmatured interest not allowable in the bankruptcy." Barry L. Zaretsky, Workouts of Troubled Loans, N.Y. L.J., May 21, 1992, at 3. Reversing the bankruptcy court, the Second Circuit established that the only difference in a participating creditor's bankruptcy claim from that of a holdout creditor "derives not from any new OID created by the exchange, but from the logical necessity of an amortization schedule that concludes on the maturity date." Chateaugay, 961 F.2d at 384. This difference is attributable to the fact that unamortized original issue discount, generated from the initial issuance and carried over to the new debt instrument, must be amortized again over the life of the new debt. Id. For a discussion of original issue discount carryover, see supra note 38.

70. Chateaugay, 961 F.2d at 382. For a discussion of face and market value exchange offers, see supra notes 30-36 and accompanying text.

71. Id. "[S]ince Chateaugay involved a face value exchange, the actual liability of the debtor to its old and new bondholders remained the same—the original face amount of the debt less the unamortized OID pertaining to the original debt." Kirschner et al., supra note 1, at 656.

72. Chateaugay, 961 F.2d at 382-83.

73. Id. at 382. As debtor corporations are excused from payment of creditor claims for unmatured interest, the Chateaugay bankruptcy court holding served to reduce corporate liability levels, by requiring that a portion of the new debt obligation established under the terms of a face value exchange represented unmatured original issue discount. Id. The debtor corporation’s balance sheet remained unaffected by a face value exchange because, by definition, face value exchanges hold the principal amount of the debt obligation constant. Id. For a discussion of unmatured interest as a disallowed bankruptcy creditor claim, see supra notes 25-28 and accompanying text. For a discussion of face value exchanges, see supra notes 33-34 and accompanying text.
In *In re Chateaugay*, the Second Circuit rendered a “much awaited opinion.” Since its creation, the LTV risk plagued bankruptcy and bondholder communities by discouraging workout and restructuring efforts. The risk permeated and impaired every out-of-court restructuring attempt, penalizing creditors and troubled companies alike. Further, the *Chateaugay* bankruptcy court’s ruling conflicted with established bankruptcy policy concerns and debt exchange procedure. Consequently, its reversal decisively restored the consensual out-of-court workout as an effective and efficient restructuring device.

The Second Circuit’s most significant accomplishment in *In re Chateaugay* was the elimination of the exchange offer participation disincentives created by the LTV risk. The consensual element of the exchange offer process traditionally functions as the greatest impediment of the approach. The LTV risk made creditor cooperation even more problematic to obtain. Recognizing the potential losses associated

74. Franklin, supra note 14, at 5. The Second Circuit’s opinion is “expected to open the door to more public companies seeking to restructure their debt out of court and avoid bankruptcy.” Id.

75. Id. The LTV risk was recognized as impacting “every major restructuring since the [LTV] case” and was deemed a “huge incentive for people not to engage in a consensual workout.” Id. Moreover, LTV risk was “counterproductive” because it discouraged the use of exchange offers designed to avoid the negative consequences of bankruptcy. *Leveraged Buyouts and Lenders’ Risks*, supra note 1, at 954.

76. See Sontag, supra note 12, at 3 (noting that LTV risk issue arose in “every out-of-court restructuring” and “people you hear in discussions or meetings are saying that the decision makes their appetite for exchange offers much less”).

77. *In re Pengo Indus., Inc.*, 962 F.2d 543, 548-49 (5th Cir. 1992). The Second Circuit’s decision “injected a new theory” of original issue discount into bankruptcy jurisprudence. Id. at 549. The Fifth Circuit emphasized that the “legal landscape eloquently pictured by the Second Circuit persuades us that, like the LTV exchange, the debt-for-debt face value exchange in the *Pengo* consensual workout did not create original issue discount for purposes of section 502(b)(2).” Id. For a further discussion of the *Pengo* consensual workout, see supra note 64.

78. For a discussion of the *Chateaugay* bankruptcy court’s ruling and the decision’s detrimental impact upon the restructuring process, see supra notes 65-73 and accompanying text.

79. Sontag, supra note 12, at 3. Convincing creditors to cooperate in a consensual workout was always difficult, but “deals got done, nevertheless, largely because they created at least the chance of avoiding the years-long, expensive” bankruptcy process. Id. For a discussion of the costs and risks associated with the bankruptcy process, see supra note 5.

80. See Sontag, supra note 12, at 3 (noting that “[t]he [Chateaugay bankruptcy court] decision takes something already difficult and makes it even tougher”); Lawrence Henry, *Bankruptcy Ruling Makes ‘Workouts’ More Difficult*, Investor’s Daily, Nov. 23, 1990, at 1 (recognizing that “[a] lender or bondholder looking at a business on the skids may therefore decide, in light of *Chateaugay*, not to do a workout or bond exchange at all”).
with the risk and with their involvement in the exchange offer process, debtholders were quick to take holdout positions to avoid the problem. The Second Circuit's reversal of the bankruptcy court's decision thus pinpointed these deviations from bankruptcy policy and ameliorated the deleterious consequences of the bankruptcy court decision.

While in existence, the LTV risk exacted a serious toll upon the workout process, bringing exchange offer negotiations to a standstill and forcing financially strapped companies to linger in their troubled condition. Moreover, the bankruptcy court's decision was the undeniable cause of numerous failed restructuring attempts and lost bankruptcy avoidance opportunities. Increased numbers of Chapter 11 bankruptcy filings followed the creation of the LTV risk, as troubled companies acknowledged the lack of debtholder participation and thereby reduced or eliminated the use of exchange offers. In order to reverse these trends, the Second Circuit examined the fundamental purposes, designs and elements of the face value exchange and corrected the flawed valuation methodology of the bankruptcy court.

Debtholder cooperation in the face value exchange process, which provides financially troubled debtor companies the much needed "breathing room" with which to relieve short-term liquidity problems, is evidence of debtholder efforts to sustain existing investments. There-

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81. Sontag, supra note 12, at 3. For a discussion of the holdout problem, see supra notes 68-69 and accompanying text.
82. Chateaugay, 961 F.2d at 382-83.
83. See Sontag, supra note 12, at 3 ("I don't think there is a single debt for debt exchange offer going anywhere at the moment.").
84. See, e.g., Robin G. Blumenthal, Bondholders in Swap Offers Given Jolt by a Bankruptcy Judge's LTV Ruling, WALL ST. J., Jan. 31, 1990, at A3 (SCI Television Inc., attempting to restructure $507 million in debt, appeared to be hampered by the bankruptcy court's creation of LTV risk); Riva Atlas, Experts Search for Solution to LTV Risk in Exchanges, INVESTMENT DEALERS' DIGEST, Feb. 12, 1990, at 18 (noting that exchanges might " 'substantially alleviate' the threat of bankruptcy" but "if there's only a marginal improvement, LTV will make exchanges much harder to do"); Franklin, supra note 12, at 5 (commenting that "[t]here's no way to quantify this, but one has to wonder how many attempted restructurings failed because of this (LTV risk) consideration").
85. See Martin I. Klein, 'Chateaugay' — The Bankruptcy Death Knell for Bondholder Workouts, N.Y. L.J., Aug. 1, 1991, at 1 (positing that "[t]he obvious impact of the Chateaugay decision is that it will greatly reduce, or eliminate, exchange offers of troubled companies"); Exchange Offers to Get a Makeover with LTV Decision, CORP. FIN. WK., Feb. 12, 1990, at 1 (stating that LTV risk "will result in substantially more Chapter 11 filings").
86. The Second Circuit emphasized that the LTV face value exchange failed to "change the character of the underlying debt" and that, therefore, the liability level of the LTV Corporation remained unaltered. Chateaugay, 961 F.2d at 382. For a discussion of the impact of face value exchanges upon corporate liability levels, see supra notes 71-73 and accompanying text.
87. Klein, supra note 85, at 1. The Chateaugay bankruptcy court "overlook[ed] the reality that in accepting the exchange, the bondholder's primary interest is to preserve their [sic] original investment by giving the issuing com-
fore, in *In re Chateaugay*, the Second Circuit properly incorporated bondholder expectations into a formula that recognized the debt-for-debt face value exchange as a mere modification rather than a complete alteration of existing debt obligations. According to the Second Circuit, debt swaps that simply alter interest rate or maturity date components do not differ from debt extension agreements in which debt obligations undergo modification but are not exchanged for new instruments. Moreover, because a creditor's fundamental motive in participating in a consensual exchange is to protect the creditor's investment by assisting the debtor company, the Second Circuit recognized that restructuring caveats included in pre-exchange offering circulars should not be afforded significance. Exchange offer materials, such as those included in the Offering Circular distributed by the LTV Corporation, frequently contain imminent bankruptcy risk warnings, an important creditor concern at the time of the original investment. However, the Second Circuit time to work out its difficulties." *Id.* For a discussion of incentives designed to encourage debtholder cooperation, see *supra* note 31.

88. The Second Circuit relied upon several cases for the proposition that face value exchanges simply reaffirm existing debt obligations. See *Chateaugay*, 961 F.2d at 382. The court first recognized the decision of *In re Red Way Cartage Co.*, 84 B.R. 459 (Bankr. E.D. Mich. 1988). *Chateaugay*, 961 F.2d at 382. In *Red Way*, a debtor company agreed to the terms of a settlement agreement that replaced an existing lease obligation prior to filing for bankruptcy. *Red Way*, 84 B.R. at 460. The settlement agreement provided for payment of the entire amount in default under the lease. *Id.* The bankruptcy court for the Eastern District of Michigan held that the debt settlement agreement "merely provided documentary evidence of the amount of the antecedent debt" rather than creating a new debt obligation. *Id.* at 461. The Second Circuit also quoted from the decision of *In re Magic Circle Energy Corp.*, 64 B.R. 269 (Bankr. W.D. Okla. 1986). *Chateaugay*, 961 F.2d at 382-83. In *Magic Circle*, a debtor company entered into a workout with its creditors prior to bankruptcy whereby existing debt obligations were restructured and replaced with promissory notes. *Magic Circle*, 64 B.R. at 270. The bankruptcy court for the Western District of Oklahoma refused to "accept the proposition that the consolidation of [debt] into a long-term promissory note wrought a metamorphosis wherein the nature of the debt was altered." *Id.* at 273.

89. Epling, *supra* note 3, at 44. For tax purposes, an exchange of old debt for debt with a longer maturity or different interest rate is no different from a debt extension agreement where the old debt instruments are merely modified and no instruments are exchanged. In the case of an extension agreement, the creditor's basis in the debt before and after the extension is exactly the same. A debt for debt exchange offer transaction is no different.

*Id.*

90. See Klein, *supra* note 85, at 1. The *Chateaugay* bankruptcy court decision "ignores the bondholder's desire to give the issuing company breathing room so it can restructure and bondholders hopefully can recover their investment." *Id.*

91. *Id.* In *Chateaugay*, old debenture holders received an Offering Circular that stated that a new note, if accepted, represented a "potential bankruptcy claim equal to its face amount . . . less unamortized original issue discount." *Chateaugay*, 109 B.R. at 56. Further, the circular expressed that exchanging debtholders "may have a smaller bankruptcy claim immediately [after issuance] than at pres-
cuit noted that these warnings serve no purpose when a troubled company is attempting a life-saving restructuring program and provide no basis for penalizing a concerned creditor who simply seeks to salvage an investment. 92

Because face value exchanges have no impact upon debtor liability levels and as the exchange between the LTV Corporation and its debtholders involved a debt-for-debt swap rather than a debt-for-equity transaction, the Second Circuit properly held that no new original issue discount was created. 93 Rather, a debt-for-debt exchange offer is original issue discount "neutral" and will not, absent a discount in the original issue itself, create any new original issue discount. 94 For this reason, the Second Circuit easily distinguished the Allegheny decision, upon which the Chateaugay bankruptcy court relied. 95 Recognizing the irrelevance of the issue, the Second Circuit refused to decide whether original issue discount emerged under the terms of a debt-for-equity exchange. 96 Indeed, according to various commentators, the inherent differences between the debt-for-equity and the debt-for-debt exchange methods rendered the bankruptcy court’s reliance upon Allegheny

ent” to the amount that the exchange involved the “issuance of New Notes at an original issue discount.” Id.

92. Klein, supra note 85, at 1. Failure to heed the Offering Circular’s warnings was one of the arguments relied upon by the bankruptcy court. Chateaugay, 109 B.R. at 56. The bankruptcy court reasoned that the consensual, voluntary nature of the LTV exchange, along with the discount warnings included in the offering circular, resulted in an informed debtholder consent to the “potential consequences” of the exchange. Id. However, the bankruptcy court “failed to appreciate the bondholder’s motives.” Klein, supra note 85, at 1. With regard to the offering circular,

[t]here is no doubt that a bondholder would value the [original issue discount] risk when contemplating his original investment. The same is not true, however, when the bondholder considers exchanging his securities. At that point, the primary concern of the bondholder is to assist the company so it will continue as a going concern, and thereby maximize the bondholders’ investment.

Id.

93. Epling, supra note 3, at 46. A new original issue discount finding serves “only to focus attention on the wrong issue and can lead to incongruous results.” Id.

94. Id. For a discussion of original issue discount in the original issue, see supra note 38.

95. Chateaugay, 961 F.2d at 383. For a discussion of Allegheny, see supra note 41 and accompanying text. Prior to the Chateaugay bankruptcy court’s decision, Allegheny was the only case ever to address the issue of discount generation from an exchange workout. Chateaugay, 109 B.R. at 55. However, the unique status of Chateaugay as a debt-for-debt face value exchange made the dispute one of first impression and simultaneously distinguishable from Allegheny. In re Pengo Indus., Inc., 962 F.2d 543, 547-48 (5th Cir. 1992). For a discussion of face value exchanges, see supra notes 33-34 and accompanying text.

96. Chateaugay, 961 F.2d at 383. The Second Circuit held that the Allegheny decision was “inapplicable to a debt-for-debt exchange such as LTV’s.” Id. For a discussion of LTV’s debt-for-debt exchange, see supra notes 15-16 and accompanying text.
erroneous.97 Similarly, the bankruptcy court’s application of tax policies and considerations to the bankruptcy question at issue in Chateaugay was an unsound approach and provided the Second Circuit an additional basis for reversal.98 While potentially persuasive, the tax treatment of a particular transaction does not override the appropriate treatments prescribed under Bankruptcy Code provisions.99 Bankruptcy policy is “rooted in the fair and equitable treatment of all creditors who are similarly situated,” whereas tax policy is predicated upon “establishing a consistent system of accounting for increases and decreases in the wealth of discrete taxpayers.”100 Accordingly, the Second Circuit held that the tax treatment of debt-for-debt exchanges relied upon by the bankruptcy court was wholly inapplicable.101

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97. Epling, supra note 3, at 43. The Allegheny decision, although “misinterpreted” by the bankruptcy court, probably is correct in holding that the exchange of preferred stock for debt created an original issue discount when the debt traded at less than par upon issuance. The debentureholders had stepped up from an equity position as the result of the exchange. Thus, the exchange resulted in an original issue of debt, subject to original issue discount. Id.; see Wilcox & Rievman, supra note 12, at 669 n.28 (noting that Allegheny is “generally perceived by bankruptcy practitioners as less disturbing than In re Chateaugay because the preferred stockholders were elevated to creditor status and as a result were given a higher priority in bankruptcy”); Saggese et al., supra note 12, at 549 n.103 (commenting that the Allegheny decision is not regarded as unfair because a stockholder exchanging his “outstanding stock for debt has elevated his status to that of creditor; consequently, it is not unreasonable that his claim should be determined by the value of the stock that he surrendered before he is permitted to share pari passu with other creditors”).

98. Chateaugay, 961 F.2d at 383.

99. Pengo, 962 F.2d at 550. “[N]o compelling need” exists for the “bankruptcy treatment and tax treatment of [original issue discount] to be similar and, for policy reasons, they should not be similar here.” Kirschner et al., supra note 1, at 655 (emphasis added). The Second Circuit relied upon the decision in In re PCH Assocs., 55 B.R. 273 (Bankr. S.D.N.Y. 1985), in support of dissimilar tax and bankruptcy treatments of original issue discount. Chateaugay, 961 F.2d at 383. In PCH, the bankruptcy court for the Southern District of New York treated an agreement, structured as a ground lease for tax purposes, as a joint venture for bankruptcy purposes. PCH, 55 B.R. at 282.

100. Kirschner et al., supra note 1, at 655-56. “The notion of equality of treatment among similarly situated creditors runs throughout various provisions of the [Bankruptcy] Code.” Id. at 660 n.56. “Although an exchange offer may present a proper time to tax the participant, that fact is not relevant in the bankruptcy analysis of the relationship that similarly situated creditors have to one another and to the debtor.” Id. at 656.

101. Chateaugay, 961 F.2d at 383. In comprehensively adopting the Second Circuit’s reasoning in Chateaugay, the Fifth Circuit articulated in Pengo that the dispute over generation of original issue discount from an exchange offer is simply “not a tax case.” Pengo, 962 F.2d at 550. The Fifth Circuit emphasized that the “tax treatment of original issue discounting does not control our inquiry, which is placed firmly within the bankruptcy framework.” Id. For a further discussion of Pengo, see supra note 64.
IV. IMPACT

The Second Circuit's *Chateaugay* decision was an influential bankruptcy resolution, with far-reaching ramifications. Refusing to "attribute to Congress an intent to place a stumbling block in front of debtors seeking to avoid bankruptcy with the cooperation of their creditors," the Second Circuit successfully eliminated the LTV risk.\(^{102}\) In so doing, the court opened the door for troubled public companies to avoid bankruptcy through debt restructuring efforts and ended an era of uncertainty and confusion in restructuring and bankruptcy communities.\(^{103}\)

First, and most importantly, the *Chateaugay* decision reinstated the consensual out-of-court workout to its appropriate status as an effective and efficient restructuring device. The elimination of LTV risk resulting from *Chateaugay* will invariably warm the chilled exchange offer waters and provide a much needed lift to consensual workouts.\(^{104}\) Troubled companies, no longer inhibited by creditor cooperation disincentives, will be able to effectively negotiate beneficial exchange offers and thereby avoid the Chapter 11 bankruptcy process through successful restructuring efforts.\(^{105}\)

Second, the Second Circuit's judgment alleviated the substantial burden placed upon restructuring specialists to develop adequate alternatives to consensual workouts.\(^{106}\) In the wake of the LTV risk, workout experts and fiscal advisors for financially troubled companies scrambled to redesign and manipulate the exchange offer process.\(^{107}\) Pre-pack-

\(^{102}.\) *Chateaugay*, 961 F.2d at 383. The Second Circuit's decision is significant for two principal reasons. Zaretsky, *supra* note 69, at 3. First, the decision "affirms in no uncertain terms that [original issue discount] can be disallowed as unmatured interest under [Bankruptcy Code] § 502(b)(2)." *Id.* Second, the decision "reduces a substantial impediment to workout negotiations by seeking to assure creditors that they will not be greatly penalized if they agree to exchange offers." *Id.* For a discussion of original issue discount as unmatured interest, see *supra* notes 21-28 and accompanying text.

\(^{103}.\) Franklin, *supra* note 12, at 5.

\(^{104}.\) Coffee & Klein, *supra* note 8, at 1249 n.121. The LTV risk "chill[s] exchange offers." *Id.* Specifically, the theory of the LTV risk is that "[b]y accepting the exchange offer, the creditor sacrifices the difference between the face amount of the securities given up and the lesser fair market value of the securities received" and that "the excess of the face amount of the new debt security over the market value of the old security on the date of the exchange (plus accreted interest) represents original issue discount and is disallowed in bankruptcy." *Id.* For a further discussion of the LTV risk, see *supra* notes 10-16 and accompanying text.

\(^{105}.\) Franklin, *supra* note 12, at 5 (stating that "[n]ow it will become at least conceptually possible for people to do out-of-court workouts again").

\(^{106}.\) *See* Atlas, *supra* note 84, at 18 (noting that LTV risk encourages development of alternatives to consensual workouts).

\(^{107}.\) *Exchange Offers to Get a Makeover with LTV Decision, supra* note 85, at 1; *see* Atlas, *supra* note 84, at 18 (stating that "[b]ankruptcy experts are franticly searching for ways to cope with the controversial LTV decision affecting par claims on exchange offers").
aged bankruptcy plans, "lock-up letters," cash sweeteners and other creative, but often tenuous, techniques evidence attempts at retaining the benefits of an exchange offer while avoiding the pitfalls of the LTV risk. Additionally, corporations attempted to force debtholders into accepting equity, rather than new debt instruments, and to somehow manipulate or modify the existing debt in a manner that did not constitute a new issuance. While innovative, these new approaches struggled to avoid the "Chateaugay minefield" and to prevent unnecessary bankruptcies. The Second Circuit's decision will put an end to the creative, but largely ineffective, ploys to avoid the LTV risk and will allow for a truly uninhibited consensual workout process.

V. Conclusion

As the inevitable outcome of an era of disastrous overleveraging, an explosion of corporate debt defaults demanded effective restructuring

108. Pre-packaged bankruptcy plans appeared to be "the most promising" LTV risk avoidance method. Atlas, supra note 84, at 18. "In a pre-packaged bankruptcy, the debtor and its creditors agree on a reorganization plan and solicit votes on the plan before commencing a bankruptcy case." Zaretsky, supra note 69, at 3. The adopted reorganization plan expedites the bankruptcy process and "enables the parties to bind dissenting minority creditors and to discharge the debtor's current liabilities." Id.; see, e.g., In re LCO Enterprises, 137 B.R. 955, 957 (Bankr. 9th Cir. 1992) (pre-packaged plan confirmed by bankruptcy court "shortly" after filing); Kirschner et al., supra note 1, at 644 (pre-packaged bankruptcy is "more expeditious and substantially less costly [restructuring] procedure"); Atlas, supra note 84, at 18 (objective of pre-packaged plan is to emerge from bankruptcy process in "three to six months"); Coffee & Klein, supra note 8, at 1247 n.112 (noting that of nine pre-packaged bankruptcies filed since 1986, seven were confirmed within five months, six of these within three months and one within five weeks).

Lock-up letters also address pre-packaged bankruptcy plan deficiencies. Atlas, supra note 84, at 18. For example, because pre-packaged plans bind only parties to the reorganization agreement, new holders, acquiring the bonds via trade during the bankruptcy process, may disagree with the terms of the exchange. Id. Lock-up letters, accepted by bondholders at the time of the reorganization agreement, require the company and "any subsequent holders of the debt to stick to the original terms of the exchange." Id.

Restructuring specialists designed cash sweeteners, cash additions to debt-for-equity exchanges, as an alternative to "straight bond for bond" exchanges and as an incentive with which to "convince bondholders that common stock or another form of equity is the best alternative" to debt exchanges. Exchange Offers to See More Cash, Stock, BONDWEEK, Feb. 12, 1990, at 1.

109. Klein, supra note 85, at 1. Debt-for-equity exchange attempts were burdened by the requirement that bondholders, already cognizant of the debtor company's financial difficulties, relinquish their position as creditors. Id.

110. Id.

111. The Second Circuit decision effectively "pave[s] the way for more restructuring transactions outside the bankruptcy courts by protecting bondholders." Second Circuit Decision on OID Should Ease Workouts, Restructuring, BNA BANKING DAILY, Apr. 27, 1992, at 15.
mechanisms.\textsuperscript{112} Consensual workouts, in the form of exchange offers, effectively assisted financially strained companies in avoiding bankruptcy.\textsuperscript{115} However, when deterred by the creation of the LTV risk, both the exchange offer mechanism and the creditors and companies it aided suffered substantially.\textsuperscript{114}

The Second Circuit’s decision in \textit{In re Chateaugay} may have offered nothing more than that for which bankruptcy experts, commentators and practitioners had been pleading since the controversial bankruptcy court holding. Nevertheless, the Second Circuit appropriately recognized the inequalities and the breaches of bankruptcy policy resulting from the bankruptcy court’s creation of the LTV risk.\textsuperscript{115} Accordingly, and appropriately, the Second Circuit completely eliminated the LTV risk.

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\textsuperscript{112} For a discussion of debt default growth and its causes, see supra notes 1-4 and accompanying text.
\textsuperscript{113} For a discussion of exchange offers, see supra notes 29-36 and accompanying text.
\textsuperscript{114} For a discussion of the LTV risk and its creation, see supra notes 10-16 and accompanying text.
\textsuperscript{115} For a discussion of the Second Circuit’s decision and analysis, see supra notes 58-73 and accompanying text.