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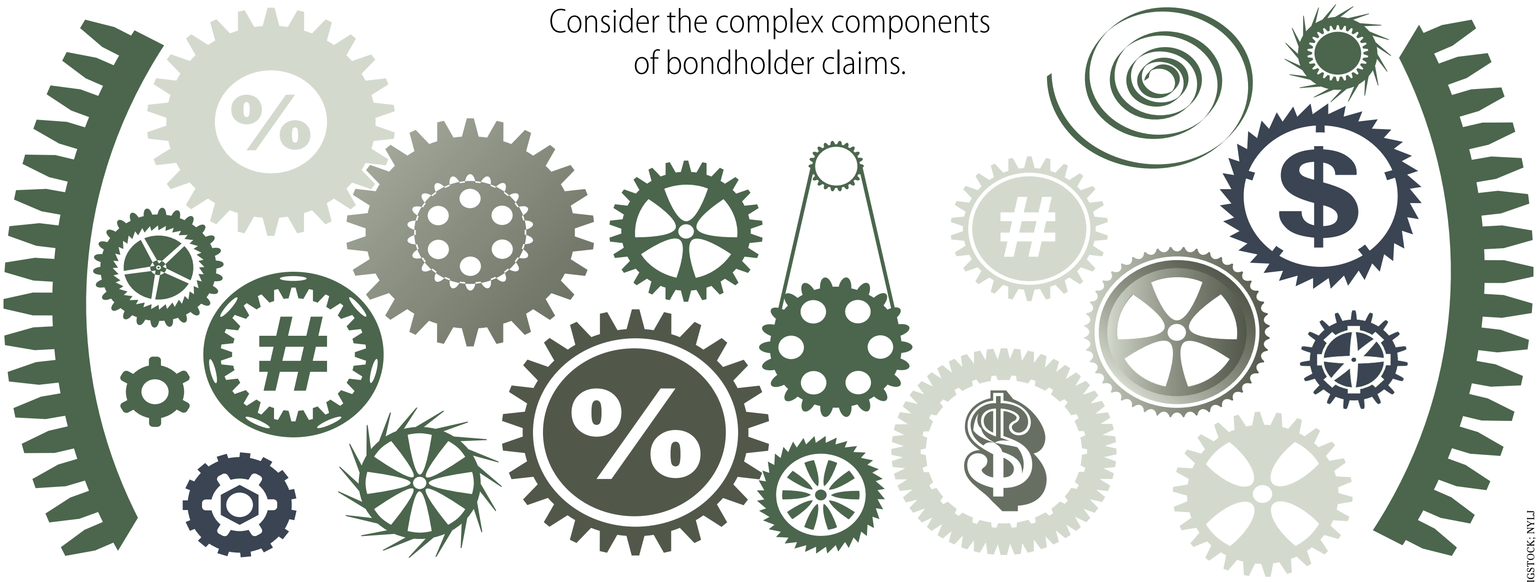
Go **Beyond** Basic Principal and Interest

Consider the complex components of bondholder claims.



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EVOLUTION in both market practice and legal jurisprudence has added complexity to calculating and asserting bondholder claims against issuers in bankruptcy. Pursuing a bondholder claim for principal and interest against a bankrupt issuer may seem simple, but complications can arise in identifying what "principal" is owing, what "interest" is a valid part of the claim, and what other amounts may be included in the claim. In part, the complexity may be a function of nomenclature and definition—for example, "make-whole premiums," "call protection," and "acceleration indemnification" are terms that, at least on the margins, may lack clear meaning and may overlap.

The complexity may also be driven by the difficulty in reconciling bankruptcy law and policy with the terms of financial instruments. For example, the bankruptcy claims process may require an understanding of the relationship between the financial term "original issue discount" and the bankruptcy law term "unmatured interest." Finally, the complexity may be promoted by a competitive marketplace in which investors seek to maximize the value of their financial instruments. This article identifies several possible components of bondholder claims, beyond basic principal and interest, and summarizes issues regarding the inclusion of those components in claims asserted in issuer bankruptcies.

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Post-Petition Interest

What is it? Perhaps the most common issue in determining the amount of a bondholder's claim is whether the claim may include interest accruing on and after the bankruptcy petition filing date—what is often called "post-petition interest."

Why is it an issue in bankruptcy? The U.S. Bankruptcy Code will in most cases not allow any claim for "unmatured interest" on an unsecured bond.[1] This limitation does not apply to the extent that the claim is secured,[2] or to the extent that the issuer is solvent and can pay all unsecured creditors in full with interest.[3] Because few issuers pay unsecured claims in full with interest, and because whether interest has matured, for claim allowance purposes, is generally measured as of the bankruptcy petition filing date,[4] these rules cause unsecured claims for post-petition interest to be disallowed as "unmatured interest" in most cases.[5]

How is it treated in bankruptcy? As noted above, the general rule is clear—the bankruptcy court will not allow a claim to include post-petition interest on unsecured bonds in cases where unsecured creditors will not be paid in full. However, that rule has its limits. Bondholders have successfully resisted the efforts of issuers to employ §502(b)(2) of the Code to "double-discount" a bondholder claim by applying a present-value discount to the principal amount of the claim and also disallowing post-petition interest.[6] Also, in the uncommon case where unsecured creditors will be paid in full and post-petition interest is appropriately included in a bondholder claim, a dispute may arise concerning whether the contract interest rate, or a statutory judgment rate, applies.[7]

The take-away. In all but the rarest cases, post-petition interest on unsecured bond claims will be disallowed, and post-petition interest on secured claims will be allowed only to the extent supported by collateral value. However, efforts of a debtor/issuer to both disallow post-petition interest and discount principal to present value have failed. Even in cases where post-petition interest on unsecured claims is allowed, it may be at a rate far below the contract rate. The general rule that post-petition interest on unsecured bonds is disallowed also informs judgments regarding other components of bondholder claims, as discussed below.

Original Issue Discount

What is it? Original issue discount, or OID, is generally understood to be the difference between the stated principal amount of a bond at maturity and the value of the proceeds of the bond paid to the obligor at issuance. For example, a bond with a face amount of $1,000 payable at maturity in 2015, and issued in 2012 in exchange for $800 in proceeds, may be said to have a $200 original issue discount. Accordingly, the total yield on a bond may include both the stated interest rate and OID, or, in the case of a zero-coupon bond, only OID.

Why is it an issue in bankruptcy? While OID can be described as principal—because when the face principal amount of the bond is paid, it will include the OID—it has characteristics of interest and serves an interest-like purpose. Because the general bankruptcy rule is that unsecured creditors may not claim post-petition interest (see above), claims of unsecured bondholders for OID that "accrue" during the bankruptcy case will draw objection.

How is it treated in bankruptcy? Again, the general rule is clear: Unsecured claims for post-petition OID are disallowed.[8] However, the rule's limits and nuances have been tested. Some issuers in bankruptcy have argued that unsecured bonds that were not described as having OID at issuance may nevertheless be deemed to have OID, and that the bondholders' claims should be reduced accordingly for unmatured OID. This issue has arisen most often when an older bond, before the bankruptcy, has been exchanged for a newer bond with different terms, or when an existing bond has been purchased on the secondary market. If both the new bond and the old bond have a face principal amount at maturity of $1,000, but the fair market value of the old bond is $900 at the time of the exchange, does the new bond carry $100 in OID?[9] What if old equity is exchanged for a new bond with a face principal amount of $1,000?[10] What if there was no exchange through the issuer, and the bondholder simply purchased a bond with a face principal amount of $1,000 on the secondary market from a prior holder, at a discounted price of $900—is there $100 in OID?[11] In more complex bond purchase and exchange transactions, the calculation of the amount and rate of OID may be in dispute, even after it is determined that some OID exists.[12]

The take-away. If OID is expressly included in the terms of a bond, it will be treated as interest and allowed as an unsecured claim only to the extent it has "matured" as of the bankruptcy petition date. OID should not be deemed to exist in "face-to-face" exchanges of old and new bonds, but there may be a risk that OID will be deemed to exist in other types of debt exchanges.[13] There is also a risk that OID will be deemed to exist in "equity-to-debt" or hybrid "debt/equity-to-debt/equity" exchanges.[14] In those circumstances, bondholders should take care to calibrate the risk of "deemed OID" to their investment objectives.

Make-Whole Premium

What is it? A "make-whole" or prepayment premium is a charge for prepaying debt. In one sense, a make-whole premium is akin to liquidated damages for the lost interest income that results from an issuer's prepayment of a bond before stated maturity. Though the bondholder may be able to place the prepaid principal and accrued interest in other investments, the market rate of interest at the time of repayment may be lower than the interest rate of the loan that was repaid. A make-whole premium is a negotiated proxy amount that "insures the lender against loss of his bargain if interest rates decline."[15, 16]

Why is it an issue in bankruptcy? Make-whole obligations are generally triggered by the issuer's prepayment. However, because the filing of a bankruptcy petition is likely to accelerate the bond debt, rendering principal and interest immediately due and payable,[17] issuers have at times asserted that the prepayment trigger cannot occur in bankruptcy, and that the make-whole premium cannot be part of a bankruptcy claim. Also, bankruptcy law and policy do not permit unsecured claims for unmatured interest and may not permit premiums on unsecured claims.[18] Some issuers may argue that make-whole premiums should be treated like unmatured interest, that specific premiums are unenforceable under state law, or that premiums may only be claimed by oversecured creditors.

How is it treated in bankruptcy? Courts have held that the automatic acceleration that occurs upon filing bankruptcy does not as a matter of law necessarily preclude a lender from recovering prepayment premiums.[19] However, bankruptcy claims for make-whole premiums may be disallowed based on the contractual automatic acceleration provisions found in most bonds, which have been construed as intentional waivers of future interest income in exchange for an immediate right to collect debt[20] and based on absence or deficiency of specific language in the bond documents regarding the premium.[21] Most bankruptcy courts hold that a prepayment charge does not amount to impermissible unmatured interest, reasoning that prepayment premiums are liquidated damages that become fully mature upon the issuer's repayment, even though the calculation of such premiums may reflect the unmatured interest that would have accrued on the loan but for prepayment.[22] Also, issuers may argue that the Code's express provision for payment of "reasonable fees, costs, and charges provided for under the agreement" for oversecured creditors should preclude any "penalty" portion of an unsecured claim, including any make-whole premium, or issuers may argue that a premium is not enforceable under applicable state law.[23]

The take-away. Properly-drafted make-whole premium provisions may result in allowable claims in bankruptcy. However, the precise wording of the provisions matters, and not all bond documents are created equal. Bondholders should look closely at the make-whole premium provisions and evaluate the risk of disallowance against precedents.

Acceleration Indemnification

What is it? Like make-whole premiums, acceleration indemnification fees are similar to liquidated damages for losses resulting from the investment having been cut short before stated maturity. Acceleration penalties, however, are designed to compensate for losses resulting from acceleration of debt upon the issuer's default, rather than losses resulting from the issuer's voluntary prepayment. As such, an acceleration indemnification clause may entitle the bondholder to damages for early repayment following acceleration, even if a make whole premium fails for reasons discussed in the prior section.

Why is it an issue in bankruptcy? When the event of default triggering acceleration, and thereby triggering the acceleration indemnification fee, is the issuer's bankruptcy, the issuer may argue that the acceleration indemnification fee is an unenforceable penalty. Additionally, in the uncommon case that the acceleration does not occur automatically upon bankruptcy filing and acceleration is instead an option of the bondholders on a bankruptcy filing, issuers may argue that acceleration during bankruptcy—for example, through the filing of a proof of claim—is prohibited by the automatic stay in effect while bankruptcy proceedings are pending.[24] Finally, because acceleration indemnification fees are designed, at least in part, to compensate for lost income, they can be likened to claims for unmatured interest, and therefore may face the same challenges of make-whole premiums, as discussed above.

How is it treated in bankruptcy? Bankruptcy decisions regarding acceleration indemnification have only begun to emerge, but one recent case provides some guidance. In *In re Saint Vincent's Catholic Medical Centers of New York*, the court allowed a mortgagee's secured claim for principal, as well as an acceleration indemnification fee for acceleration exercised by the mortgagee after the debtor's bankruptcy filing,[25] on the basis that the underlying pre-petition contract clearly provided for the fee, which was valid under state law.[26] The court found that the mortgagee's having effectively accelerated the debt through the filing of its proof of claim did not amount to a violation of the automatic stay, reasoning that creditors must have the option to accelerate for the purpose of claiming unmatured or contingent debts in the bankruptcy.[27] The court also rejected the argument that the acceleration indemnification amounted to an unenforceable ipso facto clause, as the mortgage was not an executory contract subject to the prohibition against bankruptcy termination provisions.[28]

The take-away. Coupling acceleration indemnification provisions with make-whole premium provisions may add support for bondholder claims in bankruptcy for losses resulting from the investment having been cut short, whether by prepayment or acceleration.

Conversion Right

What is it? A conversion right permits a bondholder to convert its bond into equity of the issuer. The indenture will typically specify a price—called the "strike price"—at which shares may be purchased by means of conversion. Investors are attracted to convertible security because they receive an absolute obligation of the issuer to pay interest and repay principal, but also receive an option to participate in any upside that inures to the benefit of equity.[29] The issuer, for its part, benefits because convertible debt usually carries a lower interest rate, involves less restrictive covenants, or is subordinated to other debt.[30]

Why is it an issue in bankruptcy? Convertible bonds, like most other debt securities, often include a provision for immediate and automatic acceleration of principal and interest upon the issuer's filing of a bankruptcy case. This provision, designed to ensure that the security is treated as debt to the full extent of the amount owed, may have the unintended effect of stripping the bondholder's right to demand that its debt be converted into equity. Holders of convertible debt securities should analyze whether the conversion rights remain operative in bankruptcy. If so, do they give rise to a component of a claim above and beyond the right to principal and interest? In a solvent debtor case where there is potential equity "up-side," does the convertible bondholder have a right to demand equity?

How is it treated in bankruptcy? In *In re Calpine Corp.*, the district court (reviewing de novo a bankruptcy court decision of first impression) held that the terms of the relevant indentures automatically accelerated principal and interest upon the issuer's bankruptcy filing, and that the holders of the securities were therefore entitled to such principal and interest.[31] But, the court read the indenture to eliminate the conversion right upon acceleration.[32] Thus, the holders of convertible debt had no ability to include in their claim any damages for breach of the conversion right or for the loss of those conversion rights that would capture future upside.[33] The court did state that, if any such right existed, it would be subordinated under §510 of the Code to the level of equity.[34]

The take-away. Holders of convertible debt should analyze their documents to determine if the conversion rights provide any additional value in a bankruptcy case above and beyond the right to demand principal and interest. In addition, bondholders should consider whether they can draft bond documents to preserve their conversion rights notwithstanding acceleration upon bankruptcy.

Conclusion

Bondholder claims in bankruptcy can raise complex issues, and market terms and provisions may not intersect with bankruptcy law in the manner expected by issuers and bondholders at the time of investment. The above discussion, which is not exhaustive, illustrates complexities that may arise when bondholders assert their claims in issuer bankruptcies. These complexities can cause material differences in bondholder recoveries against issuers in bankruptcy, creating a need for sound legal advice both at the time of investment and at the time of any later bankruptcy.

1. 11 U.S.C. §502(b)(2).
2. 11 U.S.C. §506(b).
3. *In re Kentucky Lumber Co.*, 860 F.2d 674, 676 (6th Cir. 1988).
4. 11 U.S.C. §502(b)
5. Notably, for insolvencies not governed by the Code, a different result may occur. See *Emps. Ret. Sys. v. Resolution Trust Corp.*, 840 F. Supp. 972, 991 (S.D.N.Y. 1993) (holding that repudiation of bond by issuer in insolvency under Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) results in damages equal to fair market value of bond upon repudiation, even if that value includes a component related to unmatured interest, as FIRREA has no equivalent of 11 U.S.C. §502(b)(2)).
6. In the *Oakwood Homes* bankruptcy, both the bankruptcy court and the district court in Delaware employed 11 U.S.C. §502(b)(2) to disallow post-petition interest and to present-value principal from the maturity date back to the petition date, resulting in a claim amount well below the original principal amount. The Third Circuit Court of Appeals reversed, holding that §502(b)(2) may be employed either to disallow post-petition interest or to reduce the expected principal and interest at maturity to the present value of that amount as of the petition date (each of which would, according to the court, create the same result), but may not be employed to do both. The majority opinion in the Third Circuit ruling rejected the logic of the concurring opinion, which reached this result on the basis that §502(b) operates to accelerate principal as of the petition date. *In re Oakwood Homes Corp.*, 449 F.3d 588 (3d Cir. 2006).
7. In the Washington Mutual bankruptcy, equity holders objecting to Chapter 11 plan confirmation argued that, under the "best interests" test for confirmation contained in 11 U.S.C. §1129(a)(7), a debtor's plan providing bondholders with post-petition interest at the contract rate was overpaying them, because in a liquidation they would receive post-petition interest only at the much lower federal judgment rate. The equity holders prevailed, with the court deciding that, in the context of evaluating the "best interests" test, 11 U.S.C. §726(a)(5) requires payment of post-petition interest (if such interest is payable) at the federal judgment rate. The court was not swayed by the bondholders' argument that an intercreditor agreement providing that the bondholders must be paid in full, including contract rate interest, before junior creditors could be paid, should mandate that the issuer pay the bondholders the contract rate (although the intercreditor agreement could permit the bondholders to receive the contract interest rate through true-up payments from the junior creditors). *In re Wash. Mut. Inc.*, No 08-12229, 2011 WL 4090757 (Bankr. D. Del. Sept. 13, 2011); see also *In re W.R. Grace & Co.*, No. 11-cv-00199, 2012 U.S. Dist. LEXIS 11289, at *281-330 (D. Del. Jan. 30, 2012) (Chapter 11 plan providing bank lenders with interest rate greater than federal judgment rate and contractual non-default rate but less than contractual default rate did not leave bank lenders "impaired," within the meaning of 11 U.S.C. §1124, because no event of default had occurred entitling such lenders to the contractual default rate).
8. A seminal decision establishing this rule is from the LTV bankruptcy case of the late 1980s and early 1990s, *In re Chateaugay Corp.*, 961 F.2d 378 (2d Cir. 1992). While the rule is not binding precedent in all jurisdictions, there are no recent decisions departing from it.
9. Probably not. The *Chateaugay* decision addressed a "face-to-face" bond exchange, where an old bond was exchanged for a new bond of equal face amount, and the Second Circuit ruled that no OID would apply to the new bond, even though the old bond may not have had a fair market value equal to its face amount as of the date of the exchange. Id. at 382. The court in *In re Pengo Indus.* Inc., 962 F.2d 543 (5th Cir. 1992), reached a similar conclusion—that an out-of-court workout involving a "face-to-face" exchange of "debt-for-debt" did not result in any OID, even if the old bonds exchanged were worth less than their face amount as of the date of the exchange.
10. Maybe. In determining whether OID exists, courts have looked to whether the face amount of the bond is in excess of the cash proceeds of the issuance received by the issuer. See *In re Pengo Indus.*, 962 F.2d at 547; *Mount Rushmore Hotel Corp. v. Commerce Bank (In re Mt. Rushmore Hotel Corp.)*, 146 B.R. 33, 34-35 (Bankr. D. Kan. 1992). Where the issuer received less than the face amount of the bond, there may exist OID. This analysis becomes complicated when a holder receives a new bond in exchange for old equity, rather than for cash. In that type of exchange, courts may look to the trading value of the new bond on its issuance date to determine the fair market value of the old equity and therefore the amount of OID, if any. See *In re Allegheny Int'l Inc.*, 100 B.R. 247, 252-53 (Bankr. W.D. Pa. 1989).
11. No. The argument that a pre-bankruptcy secondary-market sale of a bond creates OID was unsuccessfully asserted in *In re Mt. Rushmore Hotel Corp.*, 146 B.R. 33 (Bankr. D. Kan. 1992), and faces a number of legal and policy challenges.
12. See *In re Chateaugay Corp.*, 961 F.2d at 383 (discussing the straight-line and constant interest methods of OID calculation). See also *Brown v. Sayyah (In re ICH Corp.)*, 230 B.R. 88 (N.D. Tex. 1999) (applying evidentiary standards to calculation of amount of OID).
13. For example, if the face amount of a new bond is less than the face amount of the old bond for which it is exchanged, a court may inquire as to whether the face amount of the new bond includes OID.
14. The *Pengo* court expressly reserved decision for these scenarios. *In re Pengo Indus. Inc.*, 962 F.2d at 549-550.
15. *In re LHD Realty Corp.*, 726 F.2d 327, 330 (7th Cir. 1984).
16. Of course, liquidated damages for prepayment are only a proxy for prepayment damages, and a bondholder's agreement to a liquidated damages provision may result in a damages payment above or below actual damages.
17. See *In re Ridgewood Apartments*, 174 B.R. 712, 720 (Bankr. S.D. Ohio 1994) ("Even without specific contractual language, a bankruptcy filing acts as an acceleration of all a debtor's obligations."); see also *In re Manville Forest Prods. Corp.*, 43 B.R 293, 297-98 (Bankr. S.D.N.Y. 1984) (noting that "[i]t is a basic tenet of the Bankruptcy Code that [b]ankruptcy operates as the acceleration of the principal amount of all claims against the debtor…[t]his tenet follows logically from the expansive Code definition of claim…and from the Code's provision in Section 502 that a claim will be allowed in bankruptcy regardless of its contingent or unmatured status") (internal citations and quotation marks omitted), rev'd on other grounds, 60 B.R. 403 (S.D.N.Y. 1986). In addition, it is the rare debt instrument that does not include a provision automatically accelerating the principal upon bankruptcy.
18. See 11 U.S.C. §§502(b)(2), 506(b).
19. See, e.g., *In re Skyler Ridge*, 80 B.R. 500, 507 (Bankr. C.D. Cal. 1987) ("The automatic acceleration of a debt upon the filing of a bankruptcy case is not the kind of acceleration that eliminates the right to a prepayment premium…. If automatic acceleration of a debt defeats a prepayment premium clause, such a clause could never be enforced in a bankruptcy case. A debtor, under such a rule, could always avoid the effect of a prepayment premium clause by filing a bankruptcy case.").
20. See, e.g., *In re Solutia Inc.*, 379 B.R. 473 (Bankr. S.D.N.Y. 2007) (disallowing noteholders' claim for "expectation" damages for debtor's repayment of notes prior to stated maturity on grounds that noteholders had bargained for bankruptcy acceleration provision in indenture, which forfeited noteholders' future interest income stream).
21. See, e.g., *HSBC Bank USA v. Calpine Corp.*, No. 07 Civ. 3088, 2010 U.S. Dist. LEXIS 96792, at *14-17 (S.D.N.Y. Sept. 14, 2010) (denying noteholders' claims for prepayment premiums because indentures did not provide for such premiums in event of debtor's post-acceleration repayment); *Premier Entm't Biloxi LLC v. U.S. Bank Nat'l Ass'n (In re Premier Entm't Biloxi LLC)*, 445 B.R. 582, 627 (Bankr. S.D. Miss. 2010) ("[P]repayment penalties are not allowed when a loan is paid after default and acceleration unless clear contract language requires it") (internal citations and quotation marks omitted); *Solutia*, 379 B.R. at 488 (disallowing noteholders' claims for prepayment premiums for debtors' post-acceleration repayment because noteholders did not contractually provide for any post-acceleration "yield maintenance").
22. See, e.g., *In re Trico Marine Servs.*, 450 B.R. 474, 480-81 (Bankr. D. Del. 2011) (characterizing make-whole obligations as liquidated damages rather than impermissible unmatured interest). But see *In re Chemtura Corp.*, 439 B.R. 561, 604 (Bankr. S.D.N.Y. 2010) (in context of approving claims settlement, stating, "it's at least arguable that in bankruptcy cases, make-whole premiums and damages for breach of a no-call are proxies for unmatured interest—and that where unmatured interest must be disallowed, they likewise should be disallowed").
23. See 11 U.S.C. §506(b). Oversecured creditors should be entitled to contractual premiums if they are enforceable under applicable state law and either if they are reasonable, under 11 U.S.C. §506(b), or if the issuer is solvent. Unsecured creditors may be entitled to otherwise enforceable contractual premiums, but only if the issuer is solvent. See *UPS Capital Bus. Credit v. Gencarelli (In re Gencarelli)*, 501 F.3d 1, 6-7 (1st Cir. 2007). Courts may determine that certain premiums are unenforceable under applicable state law principles. See *NML Capital v. Republic of Arg.*, 621 F.3d 230, 236-37 (2d Cir. 2010) (describing standards for unenforceable penalty interest provisions under New York law); *Nw. Mutual Life Ins. Co. v. Uniondale Realty Assocs.*, 816 N.Y.S.2d 831, 836-37 (N.Y. Sup. Ct. 2006) (describing principles for enforceability of liquidated damages for lost interest under New York law).
24. *Katzenstein v. VIII SV5556 Lender, LLC (In re Saint Vincent's Catholic Med. Ctrs.)*, 440 B.R. 587, 602-03 (Bankr. S.D.N.Y. 2010); see 11 U.S.C. §362 (providing for automatic stay upon filing of bankruptcy petition).
25. The mortgagee also claimed amounts for attorney fees and costs and default interest.
26. Id. at 603-04.
27. Id. at 602-03 ("Courts have made a distinction between acceleration of a debt upon the filing of the bankruptcy petition for the purpose of the filing of a proof of claim in a case, and acceleration for the purpose of taking actions against a debtor in violation of the automatic stay") (quoting *In re PCH Assoc.*, 122 B.R. 181, 198 (Bankr. S.D.N.Y. 1990)); see also 11 U.S.C. §101(5)(A) (bankruptcy claim includes any "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured").
28. See 11 U.S.C. §365(e).
29. Richard A. Booth, Financing the Corporation §6:36 (2011).
30. Id.
31. *Aristeia Capital, LLC v. Calpine Corp. (In re Calpine Corp.)*, No. 07 Civ. 8493(JGK), 2007 WL 4326738, *9-12 (S.D.N.Y. Nov. 21, 2007).
32. Id. at *9-12.
33. Id.
34. Id. at *13.