

Oakwood Homes: Arguments Against the Strict Discounting of Damages to Petition Date

Written by:

David W. Elrod
Elrod PLLC; Dallas
delrod@elrodtrial.com

Worthy Walker
Elrod PLLC; Dallas
wwalker@elrodtrial.com

Generally accepted economic principle is that money in hand today is more valuable than a stream of payments in the future. In litigation over long-term contracts, this is a critical concept in valuing damages. Discounting recognizes the time-value of money by reducing claims for future damages to a present value. The economic impact of discounting can be huge, often amounting to millions of dollars that, in reorganizations, may flow through to other creditors and/or equityholders. Many practitioners underestimate the impact of discounting and assume that all claims must be discounted to present value as of the petition date. This is simply not the case, and there are several arguments against discounting under certain circumstances.

Outside of bankruptcy, courts nearly universally recognize that claims for future payments must be discounted to present value as of the judgment or trial. The trial date is an appropriate point to begin discounting, since all other damages have been realized by that date. In the bankruptcy context, it is argued that the Bankruptcy Code alters the customary starting point for discounting. Based on the statement contained in 11 U.S.C. §502(b) that the court should determine “the amount of such claim...as of the date of the filing of the petition,” some bankruptcy courts have held that all claims for future damages should be discounted to the petition date.

But not all courts have found §502(b) to be so clear. In the *In re Oakwood Homes* opinion, the Third Circuit Court of Appeals analyzed §502(b) at length, ultimately finding that the provision does not require such discounting in every case. *In re Oakwood Homes*, 449 F.3d 588, 596 (3d Cir. 2006). Indeed, the Third Circuit noted that a strict interpretation of §502(b) would seem to conflict with other Code provisions and basic concepts of economics. In light of the analysis provided in *Oakwood Homes* and the “absolute priority” rule,

About the Authors

David Elrod is a founding member of Elrod PLLC in Dallas and has more than 30 years of experience with trying complex commercial, business and bet-the-company cases. Worthy Walker is a trial attorney and litigator with Elrod PLLC in Dallas and is experienced in representing various businesses and financial institutions in commercial disputes.

there are several conceivable arguments against strict discounting to petition date, particularly in the “100 cent” case.

Basics of Discounting

Discount rates have long been applied to claims for future damages. Traditionally, the stated purpose of discounting is to avoid unjustly enriching a claimant without accounting for the time-value of money.

763 (Fed.Cl.Ct. 2004) (where plaintiff is not seeking “tomorrow’s dollars,” discounting is not necessary). *See also Purina Mills LLC v. Less*, 295 F.Supp.2d 1017, 1047-48 (N.D. Iowa 2003) (“[T]he portion of the total damage award that represents future damages must be discounted to present value. The damages accruing from the date of the...repudiation...through the date of judgment...is not reduced to present value, but is awarded outright.”).

Due to the language contained in §502(b), the situation is more complicated in bankruptcy litigation where a contract term runs between breach (and rejection) and the time of judgment. Clearly, a trial on a claims objection in a large reorganization may not occur for several years after the petition is filed. Debtors inevitably seek to apply a discount rate to all damages in such situations, even though the full amount of the damages has been realized by the time of trial. This is simply

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Accordingly, courts have applied discount rates to any damages that would have arisen after the date of judgment. *See, e.g., Energy Capital Corp. v. U.S.*, 302 F.3d 1314, 1332 (Fed. Cir. 2002). The customary approach is to separate the damages incurred between the time of breach and the time of trial, and award these damages outright because they have already been realized. *See Consumers United Ins. Co. v. Smith*, 644 A.2d 1328, 1341 (D.C. 1994) (“[T]here is no flaw in using actual damages for the period between breach and trial, without a discount, and then calculating the present value of future damages by discounting them only to the date of trial.”).

Even though damages going forward from breach or injury may always be conceptually “prospective,” those that occur during the months or years leading up to trial are no longer “future” damages. Therefore, when a contract term has fully run sometime after breach but before judgment, the full extent of damages has often been incurred and realized, and discounting would be unnecessary. *See Franconia Assocs. v. U.S.*, 61 Fed.Cl. 718,

counterintuitive to general concepts of expectancy damages and contract law. A creditor in this situation will already have already lost the ability to invest or earn a return on the funds, yet debtors seek to further reduce the amount of recovery by using a petition date several years in the past as a fictional benchmark for “present value.” Section 502(b) of the Code is almost always the authority cited in support of this exercise.

What §502(b) Says

As mentioned, 11 U.S.C. §502(b) is the most commonly cited authority for discounting all damages to petition date. What §502(b) actually says with respect to the determination of claims is that the court “shall determine the amount of such claim...as of the date of the filing of the petition.” 11 U.S.C. §502(b). Most debtors and their counsel assert that the term “amount” means “value,” leading to the conclusion that all claims must be present-valued at the petition date. Additionally, several courts have strictly interpreted this section to mean just that. But does “amount” really equate to “value”? And if

the intent of §502(b) was to value all claims at the petition date, why doesn't it just say so? In *Oakwood Homes*, the Third Circuit took on these interesting questions.

On the first issue, the *Oakwood Homes* court correctly noted that “[w]here the Code speaks of discounting cash streams to present value, it speaks in terms of ‘value, as of’ a certain date. It does not use ‘amount...as of,’” which is the language contained in §502(b). *Oakwood Homes*, 449 F.3d at 598. Going against the interpretation advanced by most debtors, the court went on to state that “*Nowhere* is discounting to present value mentioned...11 U.S.C. §502(b) does not contain the language used elsewhere in the Bankruptcy Code to require a present value calculation.” *Id.* at 598 n. 10 (emphasis in original).

Perhaps most interestingly, the Third Circuit provided a reasonable alternate explanation of §502(b)'s meaning, finding that the “as of the date of the filing of the petition” language simply “coincides with other Code sections that make it clear that §502 applies to a proof of claim only if it reflects a prepetition claim... Accordingly, a proof of claim should contain only claims as of the petition date...” *Id.* Logically, the court stated, “we do not believe Congress used the Code in §502(b) to require discounting to

present value where a far more simple meaning to the section accords with general principles of bankruptcy law.” *Id.*

Not Clear and Unambiguous

The most important finding of the *Oakwood Homes* court was that when §502(b) is read—as it must be—along with its legislative history and the rest of the Code, it does not require discounting in every case. *Id.* at 596. In finding so, the Third Circuit explicitly rejected the notion that §502(b) “clearly and unambiguously” requires discounting to present value, which was previously expressed by the Delaware Bankruptcy Court in *In re Loewen Group International Inc.*, 274 B.R. 427, 433 (Bankr. D. Del. 2000).

The Third Circuit noted that while many other courts have discounted claims to petition date in a blanket fashion, those courts “either conducted no inquiry at all into the issue, or concluded (contrary to our holding above) that §502(b) was clear and unambiguous.” *Oakwood Homes*, 449 F.3d at 599, n.13. Following *Oakwood Homes*, other courts have found that generalized statements that a bankruptcy court must reduce claims for future payment to present value are “overly broad.” *In re Rhodes Inc.*, 382 B.R. 550, 558 (N.D. Ga. 2008).

Discounting When Interest Is Involved


Beyond the general statements made by the *Oakwood Homes* court, the precise holding in that case was that a claim for future damages should not be discounted if the debt was interest-bearing, and the interest had already been disallowed. It stated that “the interplay between §502(b) and §502(b)(2)...acknowledges that once unmatured interest has been disallowed, discounting the remainder of the claim to present value would inequitably twice penalize the creditor for the time value of money.” *Oakwood Homes*, 449 F.3d at 601.

So, an interesting question arises as to how *Oakwood Homes* applies when a debtor's plan expressly provides for the payment of interest on claims. Clearly, the argument would be that the court should not disallow the interest payable under the plan and also discount the claim, or else the creditor would be penalized for the time value of money. Simple economics dictate that if the discount rate applied by the bankruptcy court exceeds the interest rate allowed by the plan, the creditor is paying for the time value of money, and possibly for some other risk. The issue of whether

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discount rates should build in an element of risk is topic to itself, and beyond the scope of this article.

The legislative history to §502(b) certainly appears to support the notion that a discount rate would not exceed the applicable interest rate:

Section 502(b) thus contains two principles of present law. First, interest stops accruing at the date of the filing of the petition, because any claim for unmatured interest is disallowed under this paragraph. Second, bankruptcy operates as the acceleration of the principal amount of all claims against the debtor. One unarticulated reason for this is that the discounting factor for claims after the commencement of the case is equivalent to [the] contractual interest rate on the claim. Thus, this paragraph does not cause disallowance of claims that have not been discounted to a present value because of the irrebutable presumption that the discounting rate and the contractual interest rate (even a zero interest rate) are equivalent.

H.R.Rep. No. 95-595, at 352-54 (1977) (emphasis added). *ee also* S.Rep. No. 95-989, at 62-65 (1978) (same).

When There Are No “Future Damages”

Another interesting scenario arises in bankruptcy when a long-term contract runs its course after petition date, but before the rendition of judgment. Should such a creditor be penalized for the gap in time between the end of the contract term and trial? Should a debtor be rewarded for dragging out a claims objection over several years, where the creditor has lost the ability to earn any return on the funds? Those who interpret §502(b) strictly say that equity never plays a part in the equation. Likewise, they say that the Code need not be read holistically to ensure that other policies are not tread upon. But discounting to the petition date certainly places a fictional limit on damages, shirking customary contract law and basic principles of expectancy damages. Indeed, the *Oakwood Homes* court acknowledged that “[t]he point is to recognize what the creditor bargained for, while avoiding a

windfall.” *Oakwood Homes*, 449 F.3d at 601. It is difficult to argue that a creditor actually receives what it bargained for when damages that have already been realized are discounted artificially.

The “100 Cent” Case

Yet another interesting scenario arises in the “100 cent” case, or under a plan of reorganization that envisions paying unsecured claims at 100 cents on the dollar. Certainly, where the debtor turns out to be solvent and unsecured creditors’ claims are paid in full, there is authority to support the concept that the prohibition stated in §502(b)(2) concerning the accrual of postpetition interest does not apply. *In re Manville Forest Products Corp.*, 43 B.R. 293, 300 (Bankr. S.D.N.Y. 1984) (“Therefore, when the debtor is solvent, the bankruptcy rule is that post-petition interest which accrues on unsecured claims which are allowable against the debtor’s estate will be paid in full before any money is allowed to revert back to the debtor or its shareholders.”). *See also Brown v. Leo*, 34 F.2d 127, 128 (2d Cir.1929) (“Neither the rule nor the reason for stopping interest at the date of the filing of the petition applies to an estate which turns out to be solvent.”). Unsecured creditors are generally paid post-petition interest in cases where the debtor is solvent. *See* 4-502 *Collier on Bankruptcy*, 15th Edition Rev. P. 502.03 (stating that where a debtor’s estate is sufficient to pay the interest accruing postpetition, “it would seem inappropriate for the trustee to return the surplus assets, after accommodating all creditor claims but without distributing any amount for postpetition interest, to the debtor. Therefore, in these cases, the Code does require that postpetition interest be paid to creditors before distributing the excess assets to the debtor.”). The argument follows that discounting is similarly unnecessary in the “100 cent” case, particularly when some courts seem to have found that the real rationale for discounting claims in bankruptcy court to present value as of the petition date is §502(b)(2)’s prohibition on the payment of interest that accrues post petition. *See Kucin v. Devan*, 251 B.R. 269, 273 (D. Md. 2000) (“Calculating the present value of the executives’ claims with a later date would have the impermissible effect of paying interest on an unsecured claim.”).

Furthermore, unsecured creditors are often paid postpetition interest in cases where the debtor is solvent. *See* 4-502 *Collier on Bankruptcy*, 15th Edition Rev. P. 502.03 (stating that where debtor’s estate is sufficient to pay interest accruing postpetition, “it would seem inappropriate for the trustee to return the surplus assets, after accommodating all creditor claims but without distributing any amount for postpetition interest, to the debtor. Therefore, in these cases, the Code does require that postpetition interest be paid to creditors before distributing the excess assets to the debtor.”). The authority for paying postpetition interest when the estate is sufficient to pay unsecured creditors in full is the priority scheme found in §726(a) of the Code and the absolute priority rule found in §1129(b)(2)(B)(ii). 11 U.S.C. §726(a); 11 U.S.C. 1129(b)(2)(B)(ii). *See also In re Kentucky Lumber Co.*, 860 F.2d 674, 677 (6th Cir. 1988) (“[t]his exception to the general rule helps to prevent [solvent] debtors from abusing the bankruptcy process by merely using it to delay payments and avoid interest penalties.”). These provisions require that unsecured creditors be made whole before the debtor and any old equity can receive monies from the estate. Of course, this basic principle was affirmed by the U.S. Supreme Court in *Bank of America Nat’l. Trust and Savings Assn. v. 203 North LaSalle Street P’ship*, 526 U.S. 434, 119 S.Ct. 1411 (1999).

Where the claims of unsecured creditors are being paid in full because the estate has sufficient assets, whatever is not recovered by the unsecured creditors theoretically flows to old equity. Under the “absolute priority” rule and *LaSalle*, this should not occur until the unsecured creditors are made whole. Assuming all unsecured creditors are treated the same—that is, they each have their claims determined under applicable state law—there would be no adverse impact on other creditors. *See, e.g., In re U.S. Airways Group Inc.*, 303 B.R. 784, 793-94 (Bankr. E.D. Va. 2003) (“There is nothing in the record to suggest that the other claims in the general unsecured creditor class are being allowed in an amount different from what the creditor would be owed under applicable nonbankruptcy law. So long as all claims are determined in accordance with applicable nonbankruptcy law, there

cannot be any genuine issue of disparate treatment.”). In addition, *Collier* analyzes §502(b)(2) as implementing §502(b)’s “as of the date of filing of the petition” language by disallowing post-petition interest. 4-502 *Collier on Bankruptcy*, 15th Ed. Rev. ¶502.03[3]. Citing the legislative history of §502 and the U.S. Supreme Court opinion in *Vanston Bondholders’ Protective Comm. v. Green*, 329 U.S. 156 (1946), *Collier* states that the rule is simply one of convenience: “Although different methods of considering and computing interest in bankruptcy cases are conceivable, fixing the cutoff point for the accrual of interest as of the date of the filing of the petition is a rule of convenience providing for equity in distribution.” 4-502 *Collier on Bankruptcy*, 15th Ed. Rev. ¶502.03[3][a].

Collier emphasizes that the rule is not one of substantive law: “The principle that interest stops running from the date of the filing of the petition can be viewed as a bankruptcy rule of liquidation rather than as a rule of substantive law.” *Id.* at ¶502.03[3][b][ii] (citing *Bursch v. Beardsley & Piper*, 971 F.2d 108 (8th Cir. 1992); *In re Hanna*, 872 F.2d 829 (8th Cir. 1989) (because the general rule disallowing unmatured interest is a rule of administrative convenience and fairness to all creditors, when concerns for such convenience and fairness are not present, postpetition interest will be allowed)). Thus, when a debtor is solvent, §502(b)’s “rule of convenience” should arguably yield to the priority scheme set out in §726(a) of the Code and the “absolute priority” rule of §1129(b)(2)(B). See 4-502 *Collier on Bankruptcy*, 15th Ed. Rev. ¶502.03[3][c] (“[I]t

would seem inappropriate for the trustee to return the surplus assets, after accommodating all creditor claims but without distributing any amount for postpetition interest, to the debtor.”).

Under the absolute priority rule and the authorities cited above, unsecured creditors can argue that equityholders should not receive a windfall at the expense of the creditors. Likewise, it can be argued that a solvent debtor shouldn’t be allowed to use §502(b)’s “rule of convenience” to escape or reduce legitimate claims by using the bankruptcy process, designed for insolvent entities, to enrich themselves at the expense of the unsecured creditors. All of these concepts, along with *Oakwood Homes*’ suggestion that discounting is not mandated by §502(b), would suggest that discounting is not required if all creditors are treated equally. ■

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Briggs J relied on a number of Australian authorities for his decision and compared the term “as they fall due” with the Australian “become due,” in which future debts were relevant. He held that there was a “common sense requirement” not to ignore future debts.

The implications for the interpretation of the cash flow insolvency test are yet to be fully played out. The *Cheyne* case and indeed that of the Whistlejacket SIV were distinct in that they involved fixed cash-flow profiles and determinable returns leading up to run-off. *Briggs J* in *Cheyne* highlighted that the situation may well be very different in a trading company with unclear cash-flow streams and liabilities. The *Briggs J* decision is important because it shows the need to spell out precisely the effect of complex security default provisions in complex financial documentation so that creditors can have certainty as to how the contractual provisions will allow them to enforce their security in times of insolvency. The ability to refer to future debts when considering whether a contractually defined default event has occurred may be used in the future by creditors to argue that default on a loan has occurred earlier than might previously have been possible to argue. We may see creditors using this argument to increase their leverage in workout negotiations, perhaps, for example, asking for fees for a waiver of a “default.”

Whistlejacket

The Court of Appeal decision, following a similar request for directions

from the receivers appointed for the Whistlejacket SIV, further emphasises the need to spell out with precision the effect of tailor-made provisions in highly complex structures. In this case, the documentation used the term “insolvency acceleration event,” and it was the investment manager who gave notice to the receivers that it considered such an event to have occurred. The investment manager reasoned that Whistlejacket would not be able to meet both its short-term and future liabilities (reflecting the same “pay-as-you-go” vs. *pari passu* debate as explored in *Cheyne*). This led the receivers to seek directions as to the interpretation of the relevant waterfall clause in the security trust deed. The receivers also needed to know whether the priority clause in the security trust deed imposed an obligation on them as to how money was to be paid and when.

The Court of Appeal held that the relevant clause only determined priority as between classes of creditors and not within them. The court refused to construe the clause as ranking the creditors within a class depending on the maturity date of their notes. It was held that if the contracting parties had intended the clause to have this effect, they would have been more explicit in their drafting. The court held that the position of the receivers differs before and after the insolvency of the company. Before insolvency is established the receivers can pay out to noteholders as their notes mature. Following insolvency, the receivers should exercise the normal discretion of a receiver

as to how to realise assets and when they should pay out. The priority clause could require them to withhold funds to ensure that they can meet future obligations of noteholders with later maturity dates.

Lessons to Be Learned

It will be an inevitable consequence of our challenging economic times that courts will be asked more frequently to consider elaborate, extremely technical and exotic financial structures. If the effects of the provisions are not explicit, there is a risk that the intentions of the original contracting parties may be thwarted. As held in *Whistlejacket*, if the effects of enforcement provisions are not explicitly spelt out the courts will be reluctant to imply it for you.

Both *Cheyne* and *Whistlejacket* are extremely factually specific cases. They demonstrate that receivership can be a beneficial and effective restructuring tool, at a time when it may otherwise have been displaced by administration. Of course, it should be remembered that SIVs were bankruptcy remote structures and not typical trading debtor companies. The destructive effect on value, as it is often argued receivership has, applied far less than in a normal “trading” context. However, what can be taken away is the flexibility with which a receivership might be commenced and the form it may take. Receivership, whether mandatory or voluntary, purely contractual or moulded by statutory duties and powers, can still deal an effective enforcement mechanism for secured creditors. ■