

EXCHANGE RATE RISK AND CHAPTER 11

EXAMPLE FACTS

Assume an entity files for protection under Chapter 11 on June 1

This entity has \$150m of USD-denominated bonds and E100m of EUR-denominated bonds outstanding

The exchange rate as at June 1 is 1.5000

The investor buys EUR-denominated bonds on September 1 when the prevailing exchange rate is 1.6000

The investor buys these bonds at 10 EUR cents

The company exits Chapter 11 on December 1 when the prevailing exchange rate is 1.6000

(Making this assumption isolates the exchange risk to the risk between the petition date and the trade date)

The plan recovery on the bonds is 20%

SECTION 502(b) ON THE DETERMINATION OF ALLOWED CLAIMS

Section 502(b) spells out the determination of allowed claims:

Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claims is made, the court, after notice and a hearing, shall determine the amount of such claims *in lawful currency of the United States as of the date of the filing of the petition*, and shall allow such claim in such amount, except to the extent that ---

CASE STUDY: USING ABOVE EXAMPLE FACTS

As at June 1, the allowed claims in USD terms are as follows:

\$150m	150
Plus: 1.5000 x E100m	150
Total Allowed Claims in USD	300

On September 1, the investor buys all E100m outstanding EUR-denominated bonds and pays:

0.10 EUR cents x EUR 100m	€ 10.0
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But, the investor is US-based with his currency of record denominated in USD, so he has to buy the EUR:

EUR 10m x 1.6000	\$ 16
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The US-based investor pays \$16m for E100m of EUR-denominated bonds with an allowed claim of \$150m USD
He has paid a price, in USD points of:

\$16m/\$150m	10.67%
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On December 1, he receives 20% of the \$150m allowed value in USD from the estate:

20% x \$150m	\$ 30
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In terms of EUR, he has received, at prevailing exchange rates on December 1:

\$30m / 1.6000	€ 18.8
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This gives him a recovery of:

This # divided by E100m	18.8%
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For this recovery to have been the same 20% recovery as the USD bonds received, he would have had to have paid \$15m for his EUR bds

\$15m/1.6000 as at Sep 1	€ 9.375
Expressed as a % of bond	9.375%

Economically, buying the EUR bonds in a EUR-rising environment at an economically equivalent basis would require buying the EUR bonds at a discount to the USD bonds

Had he purchased the EUR bonds at this price, his ultimate recovery would be:

20% x \$150m	\$ 30
Divided by 1.6000	€ 18.8
9.375% x EUR 100m face	€ 9.4
Return %	100.0%

This would be the same return as if he had bought USD bonds at 10% and received a recovery of 20%