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Broadening Noteholders' Ability to Receive Redemption Premiums Following Indenture Defaults

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In a decision issued on September 19, 2016, the U.S. District Court for the Southern District of New York ruled that bondholders were entitled to a "make-whole" redemption premium, as opposed to a repayment at par, following a default by the issuer under the related bond indenture. The decision raises important considerations for issuers of debt securities that contain similar provisions.

On September 19, 2016, the U.S. District Court for the Southern District of New York granted summary judgment to Wilmington Savings Fund Society, FSB, with respect to claims brought against Cash America International, Inc. in Wilmington Savings' capacity as trustee under the indenture governing $300 million of Cash America's outstanding notes. Wilmington Savings claimed that Cash America violated a covenant in the indenture when it disposed of 80 percent of a wholly owned subsidiary to its shareholders in the form of a dividend of the subsidiary's stock. Wilmington Savings also claimed that the proper remedy for Cash America's breach would be an award requiring Cash America to redeem the notes, including payment of the specified "make-whole" redemption premium under the indenture, as opposed to accelerating the maturity date and a repayment at the par value of the notes.

While the court's decision with respect to the breach of contract claim involved a relatively straightforward analysis, the claim that the holders had a right to require Cash America to pay the premium was more complex and a question that required examination of the interplay between two provisions that are customary in indentures. The first is the provision allowing an issuer to optionally redeem notes prior to maturity by paying a redemption premium, generally designed to compensate holders for the lost value from future interest payments. The second is the provision allowing holders to accelerate the maturity of notes upon an event of default, which upon acceleration requires immediate payment of the full principal amount of the notes at par. The court noted the well-established provisions of New York law that preclude the payment of a redemption premium following an automatic acceleration of notes, most commonly seen in the bankruptcy context, but further noted that in the more atypical nonbankruptcy context, the interplay between the two provisions is less clear. Specifically, the question arises as to whether the acceleration provisions in an indenture are intended to be the exclusive remedies for such a default.

In making its determination in favor of Wilmington Savings, the court referred to decision of the U.S. Court of Appeals for the 2nd Circuit in *Sharon Steel v. Chase Manhattan Bank, NA.,* 691 F.2d 1039 (2d Cir. 1982), in which the court found that the acceleration provisions in the applicable debt instrument did not bar security holders from seeking specific performance of the redemption provisions where the default resulted from "voluntary actions" by the issuer. The district court rejected Cash America's arguments that the only remedy for an event of default under a plain reading of the indenture is acceleration, specifically referencing the customary provision allowing the trustee to enforce the performance of any provision under the indenture. The court also disagreed with Cash America's interpretation of *Sharon Steel* as requiring some element of bad faith conduct, such as intentionally defaulting under the indenture to evade the payment of the redemption premium. Instead, the court stated that the analysis by the 2nd Circuit in *Sharon Steel* turned on the distinction between defaults arising from "voluntary actions" (such as the Cash America disposition) versus involuntary actions (such as bankruptcies), not subjective intent. The court also noted that the parties could have specifically included acceleration provisions that were self-operative and that Cash America could not "attempt to reap the benefit of something it did not bargain for."

The court's holding in this case raises important considerations for the many issuers of debt securities that contain similar provisions. By electing not to consider the subjective intent of the parties, the court's interpretation of *Sharon Steel* seems to broaden the requirement for payment of a redemption premium to any voluntary action taken by an issuer that results in a default under an indenture, even if the issuer may have possessed a good faith belief that such action complied with the indenture. Such actions could include transfers of assets, affiliate transactions, the incurrence of debt or liens or the making of restricted payments, which often involve calculations and judgment. As a result, issuers may face increased litigation risk from noteholders seeking to challenge actions that could arguably result in defaults as well as increased costs associated with negotiating consents or waivers under existing instruments if, under either scenario, the expected return upon a default would include the value of a redemption premium. In addition, while the voluntary actions of the issuers in this case and in *Sharon Steel* related to significant transactions that appeared to be material to the noteholders, the court imported no such standard of materiality or significance to the applicability of the requirement. This could result in unintended and potentially inequitable repercussions in future decisions.

As the case law in this area continues to develop, it is important for issuers, underwriters and their respective counsel to consider the implications of this case law when drafting the related indenture provisions. Issuers also should consider such implications when interpreting the provisions of existing indentures, particularly when doing so in connection with proposed transactions. In light of this case law, issuers, underwriters and investors may want to focus closely on the language used in both existing bond indentures and indentures for new bond offerings.