KEY POINTS
- Recent court decisions have created unpredictability in indenture interpretation while also contributing to a growing body of judicial guidance.
- Practitioners may want to make sure their intentions are set forth as clearly as possible in the text of indentures they negotiate.

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Indented: recent court decisions on New York law-governed indentures and their impact

Several recent US court decisions interpreting New York law-governed bond indentures have broken new ground, interpreting indentures in a manner that differed from the way many practitioners had done so in the past. Some of these new cases have introduced instability into the market while others have created greater certainty, but overall these cases have expanded the body of case law guiding bond practitioners. This article surveys recent key decisions turning on interpretations of terms within New York law-governed indentures that have changed the way practitioners draft and interpret these instruments.

Issuers of bonds governed by New York law indentures – the instrument containing the rights and obligations of the issuer, the trustee for the bondholders and the noteholders under the bonds – had been able to rely upon a relatively stable body of court decisions in interpreting covenants and other provisions in indentures. However, there have been a number of notable judicial decisions, particularly from appellate courts, that have impacted the interpretation of bond indentures and surprised many practitioners. These decisions may impact how issuers interpret bond indentures and may result in changes in the drafting of certain indenture provisions in the future. The following is a survey of recent key decisions turning on interpretations of terms within New York law-governed indentures that have changed the way practitioners draft and interpret these instruments.

PRINCIPLES OF INTERPRETATION

Fundamentally, New York law-governed indentures are contracts that are interpreted in accordance with general principles of New York contract law. Recent judicial decisions have reinforced this construct, building on a principle set forth in a case from the early 1980s, *Sharon Steel v Chase Manhattan Bank N.A.*, that indenture interpretation "is a matter of basic contract law".[1] In particular, the Southern District of New York's[2] decision in *Chesapeake Energy Corporation v Bank of New York Mellon Trust Company, N.A.*, 57 F. Supp. 2d 316 (S.D.N.Y. 2013) offers a roadmap to indenture interpretation under New York law. Following the basic framework for contract interpretation,[3] the court in *Chesapeake* stated that the primary objective in interpreting the terms of an indenture is that the intent of the parties is revealed in the language of the agreement. Where the text is definite and precise in meaning, it is unambiguous and therefore "the intent of the parties must be found within the four corners of the contract". If a reasonably intelligent person viewing the contract objectively could interpret the language in more than one way, then the court deems the text ambiguous and may consider extrinsic evidence as to the parties' intent.[4]

What constitutes an unambiguous text can be a matter for debate and is a question of law for the court to determine. In *Chesapeake*, the lower court determined that the text was unambiguously in favour of the issuer, only to be overruled by the appellate court holding that the text was unambiguously in favour of the noteholder plaintiffs. One member of the appellate panel dissented, claiming the text was ambiguous on the basis that the district court judge was surely a reasonably intelligent person and therefore evidence that the language was ambiguous. In evaluating whether a text is ambiguous, courts typically look at the agreement as a whole, prioritise specific language over general language, give words and phrases their ordinary meaning, examine whether a particular interpretation creates internal inconsistencies, look to commercial effect and disfavour an interpretation that renders language superfluous. When evaluating extrinsic evidence (which a court may do if it finds ambiguity in the language), courts can look to a variety of sources, including the summary of terms in the offering document, an issuer's public reports, internal reports to management, statements to rating agencies and regulators by the issuer, public declarations on investor calls, the underwriters' sale force communications to potential investors and expert testimony as well as communications among counsel and other transaction parties in the negotiation of the indenture.

RIGHT TO RECEIVE PAYMENT

In late 2014, the Southern District of New York issued a decision in *Marblegate Asset Management LLC v Education Management Corp (Marblegate)*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014), that drew the attention of high yield industry participants as well as the international financial press and demonstrated the power of litigation by noteholders. This decision also illustrated the disruptive effects on the marketplace of a court introducing uncertainty on indenture interpretation issues thought to be long settled.

Education Management Corporation (EMC) issued secured and unsecured notes governed by a New York law indenture. The notes were guaranteed by EMC's parent company, EDMC. EDMC offered to exchange the secured notes for a combination of new secured term loans and EDMC common stock. The noteholders who accepted the offer were required to consent to the release of

EDMC from its guarantee obligations (which would automatically trigger a release of the guarantee of the unsecured notes) as well as the transfer of EMC's assets to a new EDMC subsidiary, leaving EMC a shell company. The indenture permitted amendments to allow for the foregoing with the consent of holders of a majority of notes, thereby leaving unsecured noteholders and non-participating secured noteholders with notes in a company with virtually no assets, such that the issuer would be unable to meet its payment obligations under the remaining notes. Marblegate, a noteholder, argued that EMC's exchange offer was a restructuring conducted outside the US Chapter 11 process which had functionally eliminated Marblegate's right as noteholder to receive payment on its notes in violation of s 316(b) of the Trust Indenture Act of 1939 (TIA).[5] Section 316(b) provides that, for an indenture qualified under the TIA, a noteholder's right to receive payment of principal and interest from the due dates thereof or to institute suit for enforcement of such payment, may not be impaired without each noteholder's consent. This provision had generally been interpreted by practitioners as precluding changes to "money terms" of the indenture without each noteholder's consent. The court agreed with Marblegate: s 316(b) foreclosed more than just amendments to payment terms; it also prohibited actions, including indenture amendments which have the substantive effect of impairing a noteholder's right to payment without such noteholder's consent.

Two weeks later, the Southern District of New York issued an opinion in *Meehancombs Global Credit Opportunity Funds L.P. v Caesars Entertainment Corp. (Caesars)*,[6] which concurred with *Marblegate's* protection of noteholders through the relatively broad application of s 316(b) of the TIA. When Caesars was acquired by two private equity funds in 2008, Caesars attempted to move assets to affiliates and leave the debt at the operating company level, while removing a parent guarantee of the notes.[7] The indenture required consent of holders of a majority of the principal amount of the notes to release the parent guarantee and permit the asset transfer (which was otherwise prohibited under a covenant which governed a sale of substantially all of the assets of the issuer) and make the necessary modifications to the indenture – and therefore the transaction was conditioned upon such consent. Those noteholders who had consented to such modifications were able to exchange their notes for cash equal to the principal amount of the notes plus accrued interest and transactional costs.[8] Not all noteholders were given the right to participate in this consent/exchange offer: the issuer sought consents from, and offered cash in exchange for notes to, holders of a majority of the bonds but not all noteholders. Plaintiff noteholders (who were not able to participate in this consent) alleged that this transaction impaired their right to receive payment under the notes under s 316(b) of the TIA by removing the guarantee of the asset-rich company, even though the indenture, by its terms, permitted these amendments with the consent of holders of a majority of the notes, which was obtained. The court agreed and found that s 316(b) protects against more than just explicit modification of the legal right to receive payment, but also covers actions that have the effect of impairing the issuer's ability to make payments on the notes.

The long-standing understanding of many practitioners was that the application of s 316(b) was limited to explicit amendments to only the most fundamental of economic terms, such as payment of principal and interest, coupon, redemption prices and other "money terms". Practitioners widely believed that most other terms could be modified or waived by holders of a simple majority of bonds, where the indentures expressly provide that provisions can be amended by majority bondholder consent, even where such amendments could impact the issuer's practical ability to make payments under the notes. The *Marblegate* and *Caesars* decisions created significant uncertainty for issuers seeking bondholder consent to amend indentures, and for law firms who are customarily required to render legal opinions in connection with indenture amendments. Alarmed by the decisions, twenty-eight law firms issued a white paper with guidance on the issuance of legal opinions in connection with indenture amendments in light of these two decisions.[9]

Two years later, the Second Circuit reversed the district court in *Marblegate* and returned the industry to the status quo prior to *Marblegate* and *Caesars*. The court concluded that s 316(b) applied only to amendments of core payment terms. Thus, the release of EDMC's guarantee would not violate s 316(b). Noting that the scope of the "right … to receive payment" was the case's "core disagreement", the Second Circuit first looked to the text of s 316(b) and proceeded to analyse its legislative purpose and history. The court found the text of s 316(b) ambiguous with the "right … to receive payment" suggesting this could extend to a number of rights, narrow or broad. The court explained that it was unlikely that the right was intended to be broad because the TIA does not afford absolute and unconditional rights to payment.[10] The court also emphasised that broadly construing the word "right" in this context would lead to "improbable results and interpretive problems". The court proceeded to look at the provision's legislative purpose and intent and found that the relevant portions of the TIA were meant to exclusively address amendments of indenture provisions that directly impact the right to payment of the notes as required by the indenture.

Because the TIA only applies to the terms of notes that are qualified under the TIA (essentially only notes registered with the SEC) and generally does not apply to notes issued privately (typically to qualified institutional buyers), the decisions contributed to a demonstrable shift in the market away from public sale and SEC registration of notes to avoid any impact – unintended or otherwise – from the TIA with approximately 30% of US bond issuances being privately sold in 2014 as compared to over 60% in 2018. Other factors contributed to the shift, including acceptance of the private offering route by investors, speed to market and reduction of regulatory burdens of the private process.

TO MAKE WHOLE OR NOT TO MAKE WHOLE?

The following cases turn on the interplay between two customary indenture provisions. The first allows an issuer to optionally redeem

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notes prior to maturity by paying the principal amount of the notes plus accrued interest plus a redemption premium equal to the present value of future interest payments up to the first optional redemption date plus the redemption premium payable at the first redemption date (a "make-whole" premium). The second allows holders to accelerate the maturity of notes upon an event of default, requiring immediate payment of the principal amount of the notes (in the case of certain bankruptcy events, acceleration is automatic under the indenture). Traditionally, industry practitioners took the view that under customary indentures upon an event of default, the noteholders' remedy is the right to "accelerate" the maturity of the notes such that the full principal amount of the notes plus accrued interest become immediately repayable – but not any make-whole premium (unless the indenture explicitly provided for payment of a make-whole upon acceleration, which is not customary). In some recent cases, courts have ruled that in addition to an entitlement to repayment of the principal amount and accrued interest upon acceleration of notes following an event of default, noteholders may be entitled to payment of the make-whole redemption premium.

Cash America

In *Wilmington Sav. Fund Soc'y v Cash Am. Int'l Inc. (Cash America)*, Case No 15-CV-5027 (JMF), 2016 WL 5092594 (S.D.N.Y. Sep. 19, 2016), Cash America spun off a subsidiary by distributing 80% of the subsidiary's stock. The Southern District of New York found that the spin-off violated the terms of an indenture, triggering an event of default. In considering the remedy available to the aggrieved noteholders, the court noted that it is well-established under New York law that when notes are already due and payable following an acceleration of notes, and the issuer subsequently defaults, the noteholders cannot seek a prepayment premium. However, the court found that where acceleration resulted from the voluntary actions of the issuer (here, the spin-off) versus involuntary actions (eg bankruptcy events), noteholders were permitted to seek specific performance of the optional redemption provisions since to effect the spin-off validly under the indenture, the issuer would have needed to redeem the notes by paying the make-whole plus principal and interest.

The court declined to consider the issuer's motivations in undertaking the spin-off without redeeming the notes but limited its focus on voluntary versus involuntary actions. The court also noted that the parties could have included explicit language in the indenture to make clear that the make-whole was not payable upon acceleration following event of default.

In re Energy Future Holdings

In *In re Energy Future Holdings Corp. (In re Energy)*, 842 F.3d 247 (3d Cir. 2016), the Third Circuit considered whether as a result of an issuer's bankruptcy proceedings noteholders were entitled to an amount equal to principal and interest only or a make-whole premium as well. Energy Future Holdings (EFH) commenced Chapter 11 proceedings and sought to repay certain notes at principal plus interest and to refinance a portion of the notes. The indenture trustees opposed this plan and sought a declaration that the refinancing of the notes triggered the obligation to pay the make-whole amount.[11]

The district court for the District of Delaware ruled that noteholders were not entitled to the make-whole premium, on the basis that the acceleration of the notes upon the Chapter 11 filing precluded the noteholders' ability to seek the make-whole.

On appeal, the Third Circuit reversed the district court decision, finding that the refinancing of notes in the bankruptcy proceeding triggered the make-whole provision. First, the court found that the Chapter 11 resulted in acceleration of the notes, such that the notes became immediately payable. However, the court went on to find that such acceleration did not preclude redemption of the notes, finding that "redemption" does not mean "pre-payment" and therefore even if the notes had become immediately payable due to the Chapter 11 filing, the noteholders could still seek the make-whole upon a subsequent redemption of the bonds. The court dispatched the issuer's argument that the optional redemption provision and the payment upon an event of default were "different pathways" and instead found that the two provisions "formed the map to guide the parties through a post-acceleration redemption". Finally, the court found that the refinancing of the notes constituted a redemption, triggering the requirement to pay the make-whole.

Momentive

In *In re MPM Silicones, LLC. (Momentive)*, Case No. 15-1682 (2d Cir. Oct. 20, 2017), the Second Circuit considered a similar fact pattern and came to a different conclusion, reversing both the Southern District of New York and the bankruptcy court's decisions. In *Momentive*, the debtors' reorganisation plan offered the holders of two classes of notes a choice: accept the plan and receive cash equal to the outstanding principal and interest due (without the make-whole) or reject the plan and receive replacement notes, the principal amount of which would reflect the make-whole premium to the extent so determined by the court. The noteholders rejected the plan and objected. The bankruptcy court confirmed the plan despite the objections on the basis that the indenture, in its view, did not require payment of the make-whole premium.

In considering the application of the make-whole provision, the Second Circuit found that the issuance of replacement notes after the automatic acceleration did not qualify as a redemption for the purposes of an optional redemption that would trigger payment of a make-whole premium. The court emphasised that "redemption" is usually reserved for the pre-maturity repayments of debt, and in this case, acceleration moves the maturity date of debt to the acceleration date. Furthermore, the issuance of replacement notes was not optional on the part of the issuer, but rather was the result of an automatic acceleration.

The Second Circuit's decision in *Momentive* left an interpretative split between the Second Circuit and the Third Circuit's decision in *In re Energy*. The US Supreme Court has declined to review *Momentive*, leaving the circuit split on the application of make-whole provisions in the context of bond defaults in place for now. This uncertainty has encouraged more explicit language in indentures governing whether make-whole premiums are due after bankruptcy filing. The split may also encourage forum shopping on this issue.

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In re Ultra Petroleum

Recently, the Fifth Circuit also weighed-in on the applicability of the make-whole premium to bonds that had been accelerated in *In re Ultra Petroleum*, No. 17-20793 (5th Cir. Jan. 17, 2019). The case involved a relatively idiosyncratic fact pattern where the issuer entered bankruptcy insolvent and later became solvent during bankruptcy due to a rise in commodity prices. The court found that noteholders of an issuer in bankruptcy, even if the issuer is potentially solvent, are not entitled to the make-whole where the make-whole represents future interest payments.

Litigation on this point has caused the industry to reconsider the way the event of default provision is drafted. Some issuers have added language stating that no premium is payable as a result of an event of default and that the make-whole amount shall only apply following an issuer's voluntary election to redeem the notes pursuant to the optional redemption provision. Other issuers, facing resistance from investors, have refrained from adding clarifying language. The impact of the Fifth Circuit's decision remains to be seen, but because the court took the approach that, upon a default, bond holders are not entitled to the premium if it looks like un-matured interest, issuers and practitioners may be unable to draft around the ruling.

CAN THEY DO THAT?

One barrier to litigation is that an issuer's actions under the indenture are often not public. Issuers are typically required to produce annual and quarterly reports as well as certify compliance as to the covenants on an annual basis but are not required to give details on corporate actions and how such actions comply with indenture covenants. However, when an issuer's incurrences of debt are made public it creates an avenue for noteholders to challenge the issuer's interpretation of the indenture.

Norske Skogindustrier

In *Citibank, N.A. v. Norske Skogindustrier ASA*, Case No. 16-cv-850, 2016 WL 1052888 (S.D.N.Y. Mar. 8, 2016), Norske launched an exchange offer to refinance certain notes. The trustee claimed that issuing the proposed exchange notes would constitute additional indebtedness that did not fit into any of the permitted debt baskets or general "ratio debt" exception in the debt covenant of the indenture. One of the exceptions in the indenture's debt covenant allowed indebtedness incurred through any qualified securitisation financing. The issuer argued that the new notes to be issued in the exchange offer were permitted under this exception on the basis that the indenture's definition of qualified securitisation financing included "any financing" as well as any refinancing thereof. The court dismissed this interpretation on the basis that the indenture used the terms "financing" and "refinancing" differently, with "permitted refinancing indebtedness" used to refer to scenarios in which debt is renewed, refunded, refinanced, replaced, exchanged, defeased or discharged. The court then referred to *Black's Law Dictionary* for the definition of financing: the "act or process of raising or providing funds" without any suggestion of refinancing. If the issuer's arguments were right, the court reasoned, then all financing would be permitted refinancing indebtedness, rendering the defined term meaningless. In this case, the court said that the plain meanings of "financing" and "refinancing" were sufficient to be read alongside each other and without conflict.

CONCLUSION

Recent case law interpreting New York law-governed indentures and the laws that apply have concrete implications for practitioners and issuers. The volatility created by the simple act of interpretation of indenture provisions is on display in cases such as *Marblegate*, *In re Energy*, *Momentive*, and *In re Ultra Petroleum*. This trend in recent cases suggests increased potential for unpredictability as more disputes over indentures are litigated. While the Supreme Court has thus far stayed out of the fray, the pool of circuit court opinions in this area, and a lingering circuit split, may increase the likelihood of Supreme Court review. To that end, those drafting and negotiating indentures will want to make sure their intentions are written as clearly as possible in the text of the indenture itself. ■

The views expressed herein are not necessarily those of Skadden, Arps, Slate, Meagher and Flom (UK) LLP or its affiliates or any one or more of its clients.

1. 691 F.2d 1039, 1049 (2d Cir. 1982).
2. The US judicial system is separated into state and federal courts. Federal district courts are predominately trial-level courts whose decisions are appealable to the circuit (or appellate) courts. There are 13 circuit courts with regional or subject matter jurisdiction. Circuit court decisions are appealable to the US Supreme Court. Federal bankruptcy court decisions are appealable in the first instance to the relevant federal district court.
3. 57 F. Supp. 2d 316, 331 (S.D.N.Y. 2013).
4. 57 F. Supp. 2d 316, 331 (S.D.N.Y. 2013).
5. The TIA applies to indentures qualified under the TIA, which typically is limited to indentures for notes that have been registered under the Securities Act of 1933. The TIA would typically not apply to indentures for notes issued on an "unregistered" or "Rule 144A" basis that did not also involve a subsequent registered exchange offer (also called an A/B exchange). However, the language at issue in *Marblegate* and *Caesars* appears in both TIA qualified and non-TIA qualified indentures and therefore the decisions were relevant to nearly all indentures.
6. 80 F.Supp. 3d 507 (S.D.N.Y. 2015); 2015 WL 5076785 (S.D.N.Y. 2015).
7. 80 F.Supp. 3d 507, 510-11 (S.D.N.Y. 2015).
8. 80 F.Supp. 3d 507, 511 (S.D.N.Y. 2015).
9. The law firm to which the authors of this article belong is among the list of firms who issued this white paper. http://www.nortonrosefulbright.com/files/chadbourne/tia316b-opinionwhitepaper.pdf.
10. 846 F.3d 1, 8 (2d Cir. 2017).
11. 842 F.3d 247, 253 (3d Cir. 2016).

Further Reading:

- "Make-whole" provisions under New York and English law (2015) 2 JIBFL 93.
- High-yield bonds: an introduction to material covenants and terms (2014) 4 JIBFL 242.
- LexisPSL: Restructuring & Insolvency: Getting into bed with bondholders (2012) 4 CRI 120.