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When Bondholders Feel Threatened — What Relief?

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IN AN ARTICLE entitled "What Duty Is Owed in Vicinity of Insolvency," published in the New York Law Journal on Feb. 19, 2002, we previously addressed the duties owed to bondholders of companies that are in the zone of insolvency and the issues that can arise between troubled companies and their creditors. In the case discussed in detail in that article, *Fir Tree Partners L.P. v. MCG Communications, Inc., et al.*, No. 114674 (N.Y. Sup. Ct. Nov. 7, 2001) (*Mpower*), the court dismissed the complaint of noteholders who asked the court to declare that a corporation's board of directors owed a fiduciary duty to creditors when the corporation was in the zone of insolvency.

The court's decision was based on a technicality — the no-action clause in the governing indenture precluded the noteholders from taking action with respect to the indenture or the underlying notes. The article analyzed the applicability of the vicinity of insolvency doctrine and how it may protect creditors of a distressed company, as well as the potentially harmful impact a no-action provision in a governing indenture can have on this doctrine.

Since the publication of that article, bondholders have continued to try to prevent companies and their boards from taking actions that they believe violate a duty to creditors, and courts confronted with these issues have reached different conclusions depending on the facts. The three cases discussed in detail below demonstrate that there are ways for bondholders to successfully get the attention of courts, as well as the distressed companies. While there are reasons for bondholders and other creditors to be gravely concerned if company management engages in practices that jeopardize the interests of creditors, bondholders can take steps to protect their investment.

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However, in the absence of proof of insolvency or proof that a company is in the vicinity of insolvency, courts have been reluctant to create new law establishing duties to bondholders beyond those specified in the applicable indenture. Unfortunately, all actions deleterious to the rights of bondholders need not also constitute a breach of the applicable indenture and therefore may not support legal relief. Nonetheless, courts can insure that bondholders can enforce their rights based on a breach of the specific terms of the governing indenture.

When there is a breach in an applicable indenture, bondholders must keep in mind the no-action clause, which requires bondholders to comply with certain procedures prior to commencing an action, including bringing the issue to the attention of the indenture trustee and first requesting that the indenture trustee take action. See, e.g., *Mpower*. As discussed further below, not all courts agree on the applicability of no-action provisions and, even if such a provision does apply, bondholders can protect their interests by involving the indenture trustee in the process. Accordingly, relief may be available to keep the company from further impairing the bondholders' investments.

The decisions in *SpectraSite*, *Qwest* and *Lange*, each discussed below, address these issues. The diverse results of these cases indicate the different approaches courts may take when bondholders seek relief and, depending upon the approach, the risks that may arise.

The 'SpectraSite' Decision

SpectraSite Holdings, Inc. (Holdings) incurred the wrath of its public noteholders when it attempted to recapitalize by selling notes (New Notes) in a newly formed intermediate holding company (Holdco) inserted into its capital structure in an effort to avoid violating the provisions of its public debt indentures (Indentures). The proceeds of the New Notes would be offered in a subsequent tender offer to the holders of some of the existing public notes (Old Notes).

As a consequence, on June 17, 2002, beneficial owners of a majority of the Old Notes (approximately $1 billion in face value) moved the United States District Court for the District of Delaware for a temporary restraining order and preliminary injunction to prevent the recapitalization from going forward.

The plaintiffs argued that Holdings, "its officers, directors and controlling shareholders … conspired unlawfully to capture substantially all of Holdings assets — namely the shares of its wholly owned subsidiary, SpectraSite Communications, Inc. … — and transfer those shares to a newly formed entity free of the claims of the creditors of Holdings, but subject to $350 million of newly created debt held by Holdings' controlling shareholders." *Oaktree Capital Management v. SpectraSite Holdings, Inc.*, Civil Action No. 02-548 (June

17, 2002) (Memorandum of Law in Support of Motion for Temporary Restraining Order at 1).

As part of the proposed transaction, Holdings and Holdco also entered into an agreement with the controlling shareholders of Holdings, pursuant to which the controlling shareholders agreed to purchase the New Notes to be issued by Holdco and Holdings in an aggregate principal amount of $350 million. A key provision of the New Notes would limit the ability of Holdco and its subsidiaries to make distributions to Holdings. Additionally, in conjunction with these transactions, Holdings and Holdco planned to co-issue exchange notes (Exchange Notes) in the principal amount of up to $75 million.

However, the Indentures prohibited Holdings from merging with another company unless the surviving entity was also obligated to repay the Old Notes. Additionally, each Old Note restricted the ability of Holdings to sell its assets, and specified the permissible uses of the proceeds from any such sale. Further, each Indenture restricted the amount of additional financing that Holdings and its subsidiaries could incur.

District Judge Joseph J. Farnan of the United States District Court for the District of Delaware addressed these arguments in *Oaktree Capital Management v. SpectraSite Holdings, Inc.*, Civil Action No. 02-548 (June 25, 2002), first considering the legal standard for issuance of a temporary restraining order which requires courts to weigh the following four factors: (i) whether the applicant has demonstrated a reasonable probability of success on the merits; (ii) whether the applicant will be irreparably harmed by the denial of the requested relief; (iii) whether granting the relief requested will cause greater harm to the nonmoving party; and (iv) whether granting the requested relief will be in the public interest. See *Novartis Consumer Health, Inc. v. Johnson & Johnson-Merck Consumer Pharmaceuticals Co.*, 290 F.3d 578, 586 (3d Cir. 2002).

While the District Court in Delaware ultimately denied the noteholders' motion, the court found that the noteholders demonstrated a reasonable likelihood of success on the merits with respect to certain of their claims. In making this determination, the court addressed each of the provisions of the Indentures that the noteholders claimed would be violated by the company's proposed refinancing transactions. In focusing on the substance of the contemplated transactions, rather than their form, the court concluded that the recapitalization had the economic effect of a transfer, in violation of a specific provision of the Indenture.

Also, while not addressing the insolvency issues relating to the SpectraSite entities, the court concluded that the noteholders had a reasonable probability of success on the merits with respect to their claim that the recapitalization violated the indenture provision that prohibited the company from impairing the noteholders' right to receive payments of principal and interest or affecting their ability to enforce such right. Since any distribution of value from SpectraSite Communications would first be applied to pay the New Notes and the Exchange Notes, Holdco's ability to make distributions to Holdings would effectively be restricted. *Oaktree Capital Management v. SpectraSite Holdings, Inc.*, Civil Action No. 02-548 (June 25, 2002) (Memorandum Opinion at 8).

Bondholders have continued to try to prevent companies and their boards from taking actions that they believe violate a duty to creditors, and courts confronted with these issues have reached different conclusions depending on the facts.

Furthermore, in focusing on the provisions of the Indentures that limited the amount of the indebtedness of Holdings, the court found that to the extent the refinancing transactions contemplated the issuance of new convertible debt, the noteholders had a reasonable likelihood of success of establishing a violation of specific provisions of certain of the Indentures.

Additionally, because the tender offer did not require Holdings to accept all of the Old Notes tendered by the noteholders, the court found that the noteholders also had a reasonable likelihood of success with respect to its claim that Holdings violated the provisions of the Indentures that required Holdings to accept all Old Notes tendered in connection with a tender offer. Holdings' proposal would have violated this provision because it did not offer to pay consideration to each of the consenting noteholders who accepted the tender offer on Holdings' terms.

However, the court held that the other factors necessary to grant a motion for a temporary restraining order did not weigh in favor of the noteholders. Specifically, the court concluded that the noteholders could be sufficiently compensated by receiving money damages, and thus, the harm alleged was not irreparable because there was an adequate remedy at law.

Moreover, the noteholders invested in Holdings with the knowledge that their interests could be subordinated to Holdings' senior debt because the governing Indentures specifically provided for the possibility of subordination pursuant to provisions that created a credit facility basket. On the other hand, the court found that the SpectraSite entities would suffer irreparable harm if the court enjoined the proposed transactions because it was evident that the SpectraSite entities needed the financing that would result from the proposed refinancing transactions.

Lastly, the court found that the public interest factor did not weigh in favor of granting the noteholders' motion, and it agreed with SpectraSite's position that the market would appropriately value the tender offer.

While the court ultimately did not grant the noteholders' motion for a temporary restraining order and preliminary injunction, by finding that the recapitalization would violate the Indentures, the decision assured that the Old Notes would be accelerated for breach of the various provisions cited the moment the proposed transaction was completed. Not surprisingly, on Nov. 6, 2002, the company reached an agreement with the noteholders. Thus, although the court did not grant the noteholders a temporary restraining order, the noteholders' suit generated enough leverage for them to ultimately be able to protect their interests.

In situations similar to *SpectraSite*, where bondholders are able to prove to a court that a company has violated or that its proposed transactions would violate specific provisions in an indenture, the bondholders will be able to protect their interests. Even if bondholders are unsuccessful in obtaining a preliminary injunction, the combination of getting the company's attention and a court's analysis can provide bondholders with a strong negotiating position, enabling them to reach a more favorable agreement with the company outside of the court proceedings.

This is particularly the case in situations, like *SpectraSite*, where a court may not find irreparable harm, but does find a likelihood of success on the merits of the bondholders' claims, so that the company is essentially on notice that if it continues to proceed with the transaction as proposed, it is at risk that it will owe the bondholders damages.

The 'Qwest' Case

The Qwest noteholders were faced with a less straightforward problem. Qwest, in

the face of numerous disclosed accounting irregularities, sought to improve its financial condition through an exchange offer for any and all of the $12.9 billion principal amount of certain publicly outstanding notes (Qwest Notes). Holders could exchange the Qwest Notes for new ones with a higher coupon, lesser face amount and collateral or they could choose to stay where they were at the full face amount, lesser coupon and without collateral.

Those who did not tender were betting that the company would not file for bankruptcy and that they would be paid in full. Those who tendered thought there would be a filing and they would receive a priority in payment. Of course, the more noteholders who tendered, the less likely there would be a filing. What made matters worse was the complete lack of financial information about the company. Indeed, the offering circular for the exchange offer essentially said that the company had no useful information to provide.

These noteholders, in bringing a suit for a temporary restraining order, faced the risk that the leverage would shift in favor of the company if the court found that there was not a substantial likelihood of success on the merits that provisions of the indenture would be or had been violated. In *Qwest Noteholders v. Qwest Communications*, Civil Action No. 02-Civ-9660 (S.D.N.Y. Dec. 18, 2002), the noteholders brought an action alleging that the defendants' proposed exchange offer was fraudulent and coercive. Ultimately, the issuer successfully completed the tender offer after the court denied the noteholders' motion for a preliminary injunction, as the court found neither a likelihood of success on the merits of the noteholders' claims nor irreparable harm.

One of the key factors behind the court's decision centered on a specific provision of the indenture, which gave Qwest the ability to issue new debt that was senior to the existing notes. Therefore, the court reasoned that the fact that any noteholders who chose not to tender their notes would be subordinated to the new notes was not persuasive because this was part of what the noteholders had originally agreed to in the indenture. See *Qwest Noteholders v. Qwest Communications*, Civil Action No. 02-Civ-9660 (S.D.N.Y. Dec. 18, 2002) (Transcript at 35-36).

Moreover, the court was not persuaded that a risk of irreparable harm existed. "There is no change in control over structure. This is not a situation where a shareholder is tendering shares in one company for shares in [a] different company. Here there is merely an exchange of bonds. There are trading prices and these trading prices can be used to establish the amount of monetary loss." *Qwest Noteholders v. Qwest Communications*, Civil Action No. 02-Civ-9660 (S.D.N.Y. Dec. 18, 2002) (Transcript at 36-37).

In responding to the insolvency argument and concluding that there was not irreparable harm, the court reasoned that the risk of insolvency existed anyway, regardless of the exchange offer. See *Qwest Noteholders v. Qwest Communications*, Civil Action No. 02-Civ-9660 (S.D.N.Y. Dec. 18, 2002) (Transcript at 37). Additionally, the noteholders could not show a violation of a provision of the indenture or a violation of a securities law. Ultimately, the court concluded that while it was clear the noteholders did not like the exchange offer, they had failed to show a breach of contract or violation of law sufficient to support an injunction.

Although the noteholders failed in their efforts to obtain a preliminary injunction, the court did indicate (without providing specific examples) that there are certain instances where an injunction should be granted: "There are cases where irreparable harm is found." *Qwest Noteholders v. Qwest Communications*, Civil Action No. 02-Civ-9660 (S.D.N.Y. Dec. 18, 2002) (Transcript at 36).

In the absence of proof of insolvency or proof that a company is in the vicinity of insolvency, courts have been reluctant to create new law establishing duties to bondholders beyond those specified in the applicable indenture.

In that regard, not all courts agree that the threat of insolvency is not, in and of itself, deemed to cause irreparable harm. For example, *Federated Strategic Income Fund v. Mechala Group Jamaica Ltd.*, No. 99-Civ.-10517, 1999 U.S. Dist. LEXIS 16996 (S.D.N.Y. Nov. 2, 1999), involved noteholders who sought injunctive relief to enjoin the defendant from consummating an expiring tender offer.

Regarding the irreparable harm prong of their argument, the noteholders claimed that they would "not be able to obtain money damages after the offer is consummated since the proposed amendments and reorganization will render defendant insolvent." *Federated Strategic Income Fund*, 1999 U.S. Dist. LEXIS 16996, at *23. The court agreed that the noteholders "presented sufficient evidence that any non-tendering holders will not be able to recover the principal due under the notes at the time of maturity, due to defendant's planned insolvency." *Federated Strategic Income Fund*, 1999 U.S. Dist. LEXIS 16996, at *24.

Thus, it is possible that a court could determine that noteholders have satisfied the irreparable harm prong of their case if they are able to prove that the company's proposed actions will render it either insolvent or in the zone of insolvency.

'Lange' — No-Action Clauses

The *Lange* case demonstrates a third possible outcome, which is that because of a no-action clause in an indenture, a court might not reach the issue of whether the bondholders are likely to be successful on the merits of their claims.

In *Lange v. Citibank, N.A.*, No. Civ.A. 19245-NC, 2002 WL 2005728 (Del. Ch. Aug. 13, 2002), the Court of Chancery of Delaware did not address the debentureholders' specific claims. The debentureholders of Fairwood Corporation asserted that all of the subsidiaries of Consolidated Furniture Corporation (a subsidiary of Fairwood Corporation) "were sold at an unfair value to pay off debt owed to CitiCorp affiliates that was incurred in connection with the leveraged buy-out of Consolidated in which the debentures were issued." *Lange v. Citibank, N.A.*, 2002 WL 2005728, at *1. They further alleged that the sales of the subsidiaries were fraudulent conveyances that resulted from breaches of fiduciary duties.

The court denied the debentureholders' motion based solely on the no-action provision of the applicable indenture, which required the debentureholders to comply with certain prerequisites, including making a demand on the trustee, before they filed a lawsuit relating to the debentures. The court held that "the debentureholders' complaint must be dismissed because they did not follow the contractually mandated procedures that must precede a suit of this kind." Id.

The court did not agree with the debentureholders' argument that the no-action provision in the indenture did not apply to their claims because the complaint stated fraudulent conveyance claims and alleged that Fairwood and Consolidated were either insolvent or in the zone of insolvency at the pertinent times. See *Lange v. Citibank, N.A.*, 2002 WL 2005728, at *6. The court stated that "[t]o the extent that Fairwood was insolvent, its directors may have owed fiduciary duties to the debentureholders as a class, and such duties may be enforced in an action by the [i]ndenture [t]rustee." *Lange v.*

Citibank, N.A., 2002 WL 2005728, at *7.

In making its decision, the court relied on *Feldman v. McCrory Corp.*, No.Civ.A.92-11866, 1992 WL 119095, at *5, *6 (Del. Ch. June 2, 1992), which summarized the rule of law relating to the applicability of no-action provisions as follows: "Absent an allegation of fraud in the inducement of the purchase [of the debentures], clauses of this sort are generally applied to foreclose bondholder suits under the indenture where plaintiff has not complied. … [N]o matter what legal theory a plaintiff advances, if the trustee is capable of satisfying its obligations, then any claim that can be enforced by the trustee on behalf of all bonds, other than a claim for the recovery of past due interest or principle, is subject to the terms of a no-action clause."

The court in *Lange* reasoned that the debentureholders' claims are brought on behalf of the debentureholders as a class, in which case they can be asserted by the indenture trustee. Moreover, the debentureholders had contractually agreed that such claims would be subject to the no-action provision in the indenture: "[T]he particular nature of a claim that is asserted on behalf of the debentureholders as a class is not determinative of the applicability of [the no-action provision]; what is determinative is whether the claim is one with respect to the indenture or the debentures themselves." *Lange v. Citibank, N.A.*, 2002 WL 2005728, at *7.

The court viewed this standard broadly, in finding that "the debentureholders' ability to press [their] claims depends entirely on their ownership of the debentures and adverse effect that certain actions have allegedly had on each debentureholder." *Lange v. Citibank, N.A.*, 2002 WL 2005728, at *7.

The decision in *Lange* is very similar to the decision in *Mpower*, the basis for our last article, in that the *Mpower* court dismissed the noteholders' complaint, which sought to have the court declare that a corporation's board of directors owed a fiduciary duty to creditors when the corporation was in the zone of insolvency, based solely on the no-action clause in the governing indenture. The court held that any rights that Fir Tree held were created by the indenture, such that any suits thereon would be with respect to that indenture and were thus barred by the indenture's no-action provision.

However, when confronted with the applicability of a no-action provision, not every court will make the same finding with respect to its effect. In *Federated*, discussed above, the defendant argued that the noteholders' suit was barred by the no-action provision in the governing indenture; however the court found this argument to be meritless. *Federated Strategic Income Fund*, 1999 U.S. Dist. LEXIS 16996, at *23 n.7. The court added that "as a matter of equity, the offer in this action was set to expire within thirty days, well before plaintiffs could have even complied with the 60-day requirement" of the no-action provision. *Federated Strategic Income Fund*, 1999 U.S. Dist. LEXIS 16996, at *23 n.7.

Additionally, courts facing different factual scenarios have held that a party that is the cause of the failure to comply with a condition of performance cannot benefit from that failure. A party cannot rely on non-compliance with a condition precedent when that same party is the cause of the non-performance of the condition. See *Tukas Co. v. The Continuum Co.*, 00-Civ.-2762, 2001 U.S. Dist. LEXIS 1133, at *7 (S.D.N.Y. Feb. 8, 2001); see also *Merex A.G. v. Fairchild Weston Sys., Inc.*, 85-Civ.-6596, 1996 U.S. Dist. LEXIS 5946, at *15 (S.D.N.Y. April 29, 1996) (" 'A party to a contract cannot insist upon the fulfillment of a condition when he has been the cause of its nonperformance and the result would prove unreasonable and inequitable.' ") (citation omitted); *Cauff, Lippman & Co. v. The Apogee Finance Group, Inc.*, 807 F. Supp. 1007, 1022 (S.D.N.Y. 1992) ("[A] party may not rely on another party's failure to perform a condition precedent to discharge that party's obligations under a contract where that party frustrated or prevented the occurrence of the condition.").

As applied to certain factual scenarios involving bondholders facing the prerequisites of no-action clauses, it would stand to reason that if a company proposes a tender offer to close within 30 days, for example, and the no-action clause in the relevant indenture requires bondholders to give the indenture trustee 60 days to take action, then a court may not require the bondholders to comply with the no-action clause before the court is willing to address the merits of the bondholders' claim, as noted in *Federated*. It is inequitable to require bondholders to comply with the prerequisites of a no-action provision when such compliance would prevent the bondholders' claims from being heard before the company consummates the transaction it has proposed that may have a deleterious affect on the bondholders.

Of course, bondholders can still protect their interests by complying with the prerequisites of any no-action provision in an indenture. This generally requires the bondholders to involve the indenture trustee in any suit.

The indenture trustee has a duty to act, but it must also have the money to fund any such action, so typically bondholders will have to offer the indenture trustee some form of indemnity before the indenture trustee will take action. In addition, the trustee can hire the bondholders' attorneys and make the indenture trustee a nominal party to the action. Once in compliance with the no-action provision, bondholders, or the indenture trustee on behalf of the bondholders, will be able to protect their interests and will be able to get a court to address the merits of their claims, if necessary.

Conclusion

When faced with actions that jeopardize their investment, bondholders may take various actions to protect their interests. Most importantly, bondholders need to closely analyze the governing indentures and make certain critical determinations.

First, they should determine whether the actions the company proposes to take violate any of the provisions of the indenture. Second, they should determine if the indenture includes a no-action provision, and, if it does, what prerequisites must be satisfied prior to bringing an action in court.

Assuming the actions the company proposes to take would violate any provision of the indenture and the company is seeking to take those actions in a short time period, the bondholders should bring a suit to enjoin the company from continuing with the proposed transactions. Depending on the exact timing of the company's proposal, the bondholders should involve the indenture trustee, if so required by the no-action provision. If time permits, the bondholders should comply with the specific terms of the no-action provision; otherwise, the bondholders should at least attempt to involve the trustee as a nominal party in the suit they bring against the company.

Regardless of the ultimate decision that a court makes with respect to the bondholders' claims, just having their claims heard is instrumental to the bondholders' position. After obtaining the attention of the company and being heard, the bondholders can be in a much stronger position to negotiate with the company and protect their interests.

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