No, Not the End of Covenants

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Or, Some Perspective on Indenture Language Restoring the Commercial Understanding of "Make-Whole" Premiums That Prevailed Before Summer 2016

A covenant review service recently proclaimed that new language in capital markets notes indentures is "the end of covenants" and the "single worst change to ever emerge" in the bond market. We thought some historical context would be helpful.

Under a notes indenture, when notes are repaid before their scheduled maturity and a "make-whole" premium is triggered, in addition to repaying principal and accrued interest, the issuer is required to pay an amount based on the discounted value of the stream of future scheduled interest payments. Notes issued in insurance company private placements have traditionally provided that issuers must pay a make-whole upon redemption, default or bankruptcy. In contrast, high yield and investment grade notes sold into the capital markets, whether on a registered or Rule 144A basis, have traditionally provided that only principal and interest (but no make-whole) is due upon acceleration following a default or bankruptcy. However, many, but not all, fixed-rate capital markets notes also contain an optional redemption feature that allows the issuer to redeem the notes, subject to the payment of a make-whole (or other) premium in addition to principal and accrued interest.

Based on the language in traditional capital markets indentures and the clear difference in how payments on acceleration and payments on redemption are treated, we believe that many market participants and practitioners have traditionally understood that upon default or bankruptcy involving capital markets notes, holders would have a claim for principal and accrued interest on their accelerated notes and no more. A few courts, including the U.S. Second Circuit in *Sharon Steel* (1982), have recognized a narrow exception in the case of an issuer that intentionally triggers acceleration with the goal of avoiding a redemption premium, with the courts requiring such an issuer to pay the redemption premium. Few reported cases have found conduct that merits application of the *Sharon Steel* exception.

Two recent decisions have upended these settled expectations (we discussed these decisions in an **earlier memo**). In *Cash America*, decided in September 2016, a U.S. district court held that a make-whole is payable where a company defaulted through voluntary action without a finding that the company had acted in bad faith with an intent to avoid the make-whole. In *Energy Futures*, decided in November 2016, the U.S. Third Circuit held that a company must pay a make-whole if notes are repaid in a bankruptcy.

Not all capital markets notes include an optional right of redemption. We believe that market participants and practitioners have generally understood that an issuer's right of redemption, including at a stated premium or make-whole, exists to provide flexibility for the benefit of the issuer. It would be odd, to say the least, if when an issuer defaults on notes without this feature, the issuer only has to pay principal and interest, but if that additional feature is included – *for the issuer's benefit* – the issuer must pay a premium.

Given the uncertainty created by the *Cash America* and *Energy Futures* decisions, a number of issuers have added language to their capital markets indentures to clarify the understanding that no make-whole is due upon a default or bankruptcy.

The one potential change that this language could have made to prior expectations involves the narrow *Sharon Steel* exception: if an issuer intentionally defaults in order to avoid the make-whole, the new language could suggest no premium is due – although holders would undoubtedly argue otherwise on grounds that the issuer acted in bad faith. Regardless, we do not view this as having much of an impact on issuer behavior: as a practical matter, *companies rarely intentionally default*. Doing so triggers any number of negative consequences for the issuer, including cross defaults in other debt, cross defaults in hedges, leases and other financial obligations, supplier retraction of credit, going-concern qualifications in financial statements and loss of shelf registration statement eligibility. Moreover, a company that tried to do so, such as a company that is the subject of a leveraged buyout, would undoubtedly be sued and risks the issuance of injunctive relief, in which case the company could not act without redeeming the notes or obtaining noteholder consent. Accordingly, this potential change is not really much of a change at all from what has been, in our view, established practice.

While ultimately issuers and investors face a commercial decision on how and whether to address the uncertainty created by *Cash America* and *Energy Futures*, if investors are concerned about foreclosing their right to argue for application of the narrow *Sharon Steel* exception, the new language could easily be modified to say that it does not apply to intentional defaults caused in order to allow voluntary prepayment of debt without paying a make-whole – and "the end of covenants" can be postponed until another day.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Richard A. Drucker	**212 450 4745**	**richard.drucker@davispolk.com**
James A. Florack	**212 450 4165**	**james.florack@davispolk.com**
Joseph A. Hall	**212 450 4565**	**joseph.hall@davispolk.com**
Sophia Hudson	**212 450 4762**	**sophia.hudson@davispolk.com**
Michael Kaplan	**212 450 4111**	**michael.kaplan@davispolk.com**
Nicholas A. Kronfeld	**212 450 4950**	**nicholas.kronfeld@davispolk.com**
Byron B. Rooney	**212 450 4658**	**byron.rooney@davispolk.com**
Richard D. Truesdell, Jr.	**212 450 4674**	**richard.truesdell@davispolk.com**