INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

Volume 22 Number 2, February 2008

SECURITIES MARKETS

Reflections on Indenture Remedies and Investor Protection

Recent activism by institutional investors regarding alleged breaches of non-financial covenants in indentures has brought to light a potential disconnect between these covenants and the severity of the remedy available in response to a breach. Issuers also are can be surprised to learn how small a holding of their debt securities is needed to initiate acceleration. Courts have grappled with this issue with mixed results, and efforts to recast traditional indenture remedy provisions have produced inconsistent approaches.

by Bruce C. Bennett

It is axiomatic in contract drafting that the remedy for failure to adhere to a contractual obligation should be designed to deter non-compliance and also to protect the interests of the non-defaulting party. This instinct for calibration is well-founded in US jurisprudence[1] as well as in its historical antecedents.[2]

In the realm of indentures and related documentation governing fixed-income securities, one can argue that the traditional remedy structure for certain covenant breaches fails this calibration standard. The typical contractual remedy for covenant breaches has been acceleration. This is a severe remedy.[3] There is, however, no question that this is an appropriate remedy for payment defaults (whether in the subject securities or by means of cross-acceleration to another obligation for borrowed money). Acceleration is also the only viable remedy for incidents of bankruptcy or insolvency. Investors' expectations of repayment in these circumstances are altered dramatically, and they are entitled to immediate protection.

Similarly, for many of the covenants contained in high-yield transactions, such as restricted payment, debt incurrence, asset sale, and change in control covenants, acceleration is generally a remedy appropriately calibrated to the risk imposed on the investor in the event of a breach. These covenants are designed to provide early warning signs of potentially imminent payment difficulties, and given the tenuous credit of the issuer, it is appropriate to impose acceleration as the sole contractual remedy. However, because the linkage between breach of these covenants and a subsequent payment default is not as direct as is the case with payment and bankruptcy covenants, a grace period typically must elapse and requisite holders must deliver a formal written notice of acceleration to the trustee before the acceleration remedy is available.

There are other covenants, however, that do not involve payment obligations or otherwise transmit a reliable warning sign that payment by the issuer is

Bruce C. Bennett is a partner at Covington & Burling LLP in New York, NY. The assistance of Nicole S. Emch, formerly an associate at Covington & Burling, is gratefully acknowledged.

in imminent jeopardy. It is nonetheless common for the same acceleration remedy that applies to these higher risk covenants to also apply to these arguably less critical non-financial covenants.

Why should we care about this potential disconnect between the import of the breach and the severity of the remedy? Just as in any form of arbitrage, it creates an opportunity for value creation (or, depending on one's vantage point, value extraction) in circumstances that, in retrospect, may fairly be viewed as not what the parties to the transaction envisioned in structuring the securities. As discussed below, recent institutional investor activism in this area has caused minor breaches of arguably less critical indenture covenants to result in situations that have threatened the very existence of otherwise viable issuers. This situation confers leverage upon investors that may be disproportionate to any harm they have suffered or may suffer in the future. To analyze this issue, first we need to review the underlying transactional and documentary architecture in this area.

Capital Markets or Bank Financing?

Historically, a company in need of fixed-income financing had two choices: (1) issuing securities in the capital markets; or (2) borrowing funds from banks.[4] Well-advised borrowers tended to select from both alternatives, depending on their needs and market conditions.

Among the factors favoring the capital markets included historical advantages in terms of speed (particularly after the advent of shelf registration in the early 1980s and the development of the Rule 144A markets in the early 1990s), the ability to tailor a transaction to a specific need, the ability to finance without needing to agree to financial ratio and other maintenance covenants typically favored by banks and the availability of different sources of capital (retail, institutional, domestic, foreign).

On the other hand, banks could have historical relationships with borrowers that facilitate efficient structuring and execution. Accessing this form of capital does not involve SEC registration (or the perfection of an exemption). The borrower could enter into a facility permitting deferred drawing of funds from time to time on a committed and revolving basis. Finally, and perhaps most significantly, it generally is viewed as far easier to obtain amendments of covenants and waivers of non-compliance from the lending group than from disparate holders of debt in the capital markets.

While borrowers would not incur debt expecting to need subsequent waivers from covenants or other obligations, the need for relief can arise in even the best-structured deals. In the capital markets context, waivers (other than waivers involving payment defaults) or other amendments typically require a majority in principal amount of the affected series or issuance of debt to consent. With the evolution of book-entry securities and the separation of security ownership from any tangible evidence thereof, tracking holders has become a difficult task. As a result, in order to procure consents, issuers typically must pay fees designed to provide sufficient economic incentive to the beneficial holders to undertake the effort to cast a vote.

In bank financing, on the other hand, even after a loan is syndicated, and even if there is secondary trading in the paper, the lead bank or administrative agent will have a register of lenders, which it can access as needed if the lender needs a consent or amendment. While these agreements do not come without a cost, the fees may be less and the ability to locate the requisite lenders is far more certain in a bank financing structure. Perhaps most significantly, the waiver or consent generally can be procured more quickly than in a capital markets transaction.[5]

Despite this distinction, borrowers entering into capital markets transactions in the United States[6] do so with a reasonable expectation that, should the need arise to obtain consents or waivers or otherwise amend the transactional documentation, for payment of a reasonable consent fee and in the absence of exigent circumstances, the requisite consents can generally be procured.

Remedies and Amendments under Fixed-income Documentation

Indentures typically are governed by New York law (although, in the case of issuances in non-US

markets, the law of the United Kingdom or other major market centers may govern).[7] As a contract between the issuer and the trustee, acting on behalf of the beneficial owners of the underlying securities, breaches are subject to general contract remedies of the law governing the indenture. Far more customary, however, is for aggrieved lenders to rely on the explicit acceleration provisions contained in the indenture for their remedial protection.

Typically, acceleration occurs automatically upon the occurrence of a payment default or an event of bankruptcy or insolvency. Any other event of default typically carries with it a grace period (often 60 days in duration), after which holders of at least 25 percent aggregate principal amount of the securities can, by notice to the trustee, require the trustee to accelerate the debt, unless the breach is cured or waived. The trustee also can initiate an acceleration without receipt of instructions from requisite holders, although this rarely occurs. Once acceleration is initiated, holders of not less than 50 percent aggregate principal amount of the securities are required to agree to any rescission of the acceleration or waiver of the default.

If an issuer were to seek to amend an indenture (which can include an amendment that waives a past or continuing default that has yet to give rise to an acceleration), there typically are three potential outcomes. If the amendment affects payment, maturity or other fundamental economic terms, every holder must consent to the amendment. If the amendment involves the correction of a clear error in the indenture, or involves a change that is not adverse to the holders, then the trustee will execute the instrument effecting the amendment without any consent from any holders.[8] Amendments not falling within either of these categories require consent from a specified subset of holders, typically a majority, but in some cases two-thirds, of the aggregate principal amount of the securities in question.

Fixed-Income Documentation Structure

Historically, debt was issued pursuant to transaction-specific documentation, mirroring SEC registration structures of the time. If an issuer were to issue $100 million aggregate principal amount of 10-year notes bearing interest at an annual rate of 8.5 percent, an indenture would be created governing this issuance, and this issuance alone. If a default occurred that did not give rise to automatic acceleration, holders of at least $25 million aggregate principal amount of the notes would be required to deliver a notice to the trustee instructing it to accelerate. If holders of at least $50 million aggregate principal amount of the notes disagreed with this action, or if the issuer were able subsequently to convince those holders that acceleration was unnecessary to protect their interests, those holders could instruct the trustee to rescind the previously-delivered acceleration notice and waive the default.

With the advent of shelf registration and the ability to register multiple issuances in a single SEC filing, debt documentation shifted from this transaction-specific mode to a more global structure. Under "open-ended" indentures, an issuer and a trustee execute an indenture that allows for multiple issuances from time to time, pursuant to issuance procedures set forth in the indenture. While initially these indentures were subject to aggregate maximum amounts of debt that could be issued, typically this limit is no longer imposed, such that the indenture can be used to issue an unlimited amount of debt securities.[9] Each discrete issuance of securities under an open-ended indenture typically is referred to as a series.

Remedy exercise, remedy cancellation, and amendment rights under open-ended indentures theoretically can be calibrated in one of two ways: (1) either all debt outstanding under the indenture is considered as a single class, or (2) series-specific measurements are made. Assume an open-ended indenture pursuant to which an issuer has issued seven discrete series of debt securities in an aggregate principal amount of $850 million, in series ranging from $25 million aggregate principal amount to $200 million aggregate principal amount. In the single class structure, holders of $212.5 million aggregate principal amount of debt (25 percent of $850 million) would have to notify the trustee to accelerate if an event of default occurred that did not otherwise provide for automatic acceleration. Because this amount is larger than the largest series outstanding under the indenture, holders of multiple series would be required to act in unison to cause acceleration,

and holders of smaller series would have little ability, acting alone, to protect their interests. Similarly, assuming a 50 percent amendment threshold for non-economic, non-immaterial amendments, holders in excess of $425 million aggregate principal amount would have to agree in order for any such amendment (or waiver of a past default) to take effect.

Conversely, in a series-specific structure, holders of each series would be able to take, or refrain from taking, action as to their series of securities, and also would be unaffected by action taken by holders of other series (subject to cross-acceleration provisions, which are discussed below). This arguably better calibrates these rights to the interests of the noteholders. There is a cost to the issuer, however. Should the issuer seek amendments or waivers, it must obtain them from holders of multiple series of securities, which increases the potential holdout risk, with its concomitant increase in cost.[10] This holdout risk is further increased by the smaller size of certain series under the indenture. In our hypothetical, an investor seeking to play this role need only place slightly more than $12.5 million of its capital at risk to acquire a majority in principal amount of the smallest outstanding series under the indenture.

The advent of medium-term note documentation further adds to this complexity. These programs started in the early 1980s as a new third prong to the standard litany of financing alternatives—between the short-term funding provided by commercial paper programs (which typically involve maturities of less than 270 days to be able to qualify for the exemption from SEC registration afforded by Section 3(a)(3) of the Securities Act) and long-term funding provided by long-term debt issuances, which at the time generally were viewed as having maturities in excess of five years. At the outset, these programs were designed to operate largely on a reverse-inquiry basis, under which investment banks named as underwriters on the program would bring to the issuer offers from buy-side institutional investors to purchase securities in specific principal amounts and of specific maturities that met a specific need of that investor. These criteria were often in unrounded amounts, *i.e.*, an issuance of $74,238,543.50 aggregate principal amount of securities maturing in three years, 7 months and 11 days. These metrics were often driven by specific investment needs of the investor, for example, an insurance company that was receiving funds from a maturing investment and needed to reinvest those proceeds to a specified date by which it needed the investment to mature.

Over time, the distinction between medium-term and long-term notes has disappeared, such that MTNs are no longer viewed as a discrete investment product. MTN documentation has proven attractive to many issuers because it offers a streamlined means by which to issue debt securities. Therefore, many frequent issuers now rely solely on MTN documentation for all but commercial paper debt issuances. This development is of note because under these programs, issuers often receive reverse inquires for very small principal amounts of debt, often, less than $5 million. If such an issuer has series-specific documentation, then it creates separate consent, amendment and acceleration rights in very small and concentrated series of securities, and gives the holders of those securities inexpensive means by which to impede the issuer's plans.

Cross-Acceleration vs. Cross-default

Among the events of default under a typical indenture is the cross-acceleration or cross-default provision. Under cross-default, it is an event of default under the indenture if the issuer defaults under any other debt obligation. This right is often (but not always) subject to a materiality threshold. A cross-acceleration provision requires that, in order to constitute an event of default under the indenture, the default in respect of the other outstanding debt obligation must have in fact been accelerated. This difference is important, as it enables an issuer to avoid the potentially catastrophic consequences of cascading accelerations due to a technical default under one outstanding issuance if it can convince the holders of the affected debt that they need not accelerate to protect their interests. As noted, acceleration can be a blunt and ineffective instrument. If the issuer is in financial distress, it likely will not have the cash needed to repay debt prior to scheduled maturity. Cross-acceleration provisions accommodate this concern by providing the issuer an opportunity to work with its creditors without defaults automatically occurring across its financing

structure. Cross-acceleration is thus customary, although cross-default provisions continue to be used, particularly for lesser credits.

Institutional Investor Activism Relating to Non-financial Covenants

Having laid out the basic documentary architecture, we can now analyze how recent activism in the fixed-income markets by certain institutional investors occurs.[11] This activism typically has focused on a single non-financial indenture covenant—the SEC reporting covenant—although it has occurred in other contexts. The strategy outlined below works regardless of the rating of the issuer. An investment grade issuer that misses an SEC filing is equally at risk as an issuer saddled with high yield rates. This often is a shocking realization for investment grade issuers, which had heretofore understood that so long as they retained their investment grade status and serviced their debt on a timely basis, the risk of acceleration of an issuance of debt, or even worse of cross-acceleration of other debt, was extremely remote.

The SEC reporting covenant historically has existed in two forms, which for ease of reference we will call the "restrictive" and "flexible" versions. Under the restrictive version, the issuer agrees to deliver to the trustee copies of all reports it is required to file with the SEC under the Securities Exchange Act of 1934 (Exchange Act) by the date that these filings are due with the SEC or within a brief period of time, typically 15 to 30 days, thereafter. Under the flexible version, the issuer agrees to deliver to the trustee copies of its SEC reports promptly after filing them with the SEC. If the issuer misses an SEC filing deadline for one of these reports, it breaches the restrictive version of the reporting covenant, but does not breach the flexible version.

Either version of the covenant also will require the issuer to comply with Section 314(a) of the Trust Indenture Act of 1939 (TIA), which requires the issuer to:

> file with the Indenture Trustee copies of the annual reports and of the information, documents and other reports . . . which such obligor is required to file with the [SEC] pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 . . . .[12]

In recent years, the incidence of restatements of audited financial statements by US public companies has risen significantly.[13] Restatements often take many months to complete, and auditors often withdraw their audit opinion on the most recent audited financial statements during the duration of the restatement. An issuer thus may find itself unable to file its Annual Report on Form 10-K during a restatement, since it cannot procure the audit opinion required by that form. While it can file its Quarterly Reports on Form 10-Q, it cannot procure the review by its auditors required by SEC rules.[14] The absence of that review, even though it is not the same as a full audit, renders the 10-Q a non-compliant filing and the issuer thus is deemed not to be current or timely in its Exchange Act filings.[15] Therefore, during this period, the issuer cannot file with the trustee its annual reports on Form 10-K, because it cannot file those reports with the SEC in the absence of an audit opinion, and it cannot file with the trustee a quarterly report on Form 10-Q that complies with its obligations under Sections 13 or 15(d) of the Exchange Act, because the quarterly report, lacking the required auditor review, is non-compliant under SEC rules.

> Under the flexible version of the reporting covenant, these factors do not constitute a breach of the covenant. Under the restrictive version of that covenant, however, the issuer will be in breach, and in many cases the issuer is not able to remedy this breach prior to the expiration of any grace period afforded by the remedy provisions of the indenture. In this event, the issuer is at risk of acceleration. Historically, however, investors rarely availed themselves of this right. Restatements were rare, and investors typically were willing to work with the issuer. Based on this behavior, the question of whether acceleration was an appropriate remedy for this default generally was not considered.

Recently, however, institutional investors have aggressively been pursuing their rights under the reporting covenant in the event of a restatement.

Even if the issuer is providing periodic updates to its investors as to its financial position and results of operations on an unaudited basis, typically by the submission of Current Reports on Form 8-K to the SEC, these investors have assembled positions in excess of 50 percent of the relevant series and instructed the trustee to accelerate. Their holding is large enough not only to permit them to force acceleration, but also to block any efforts by other holders to rescind the acceleration or waive the default. Armed with this position, the investors enter into negotiations with the issuer seeking significant fees in exchange for their agreement to rescind their acceleration demand. Their leverage is enhanced by the typical cross-acceleration provision contained in the issuer's other financing documents, which, if triggered, would permit all other debt holders to accelerate their obligations, which could render the issuer insolvent.

It is important to note that, in the above situation, if the indenture in question contains the restrictive version of the reporting covenant, then the investor is fully within its rights in taking these actions. Whether that is what the parties had in mind when they created the indenture may be another story, but as a matter of contract law, the meaning of the provisions are clear, and a court is unlikely to second guess the intent of the parties, regardless of how extreme the result.[16]

Recent Judicial Decisions

In one recent case,[17] a court found that, even under the flexible version of the reporting covenant, a company's failure to file SEC reports when required by the SEC constituted an event of default under the indenture. In December 2004, BearingPoint, Inc. issued two series of convertible debentures. The offering memorandum explained that BearingPoint might be unable to file its 2004 10-K with the SEC on time because of the existence of material weaknesses in the company's internal controls. BearingPoint was indeed unable to file its 2004 10-K or its 10-Qs for the first and second quarters of 2005 with the SEC on time.

The indenture under which the convertible debentures had been issued contained the flexible version of the SEC reporting covenant, which required BearingPoint to file with the trustee:

> within 15 days after it files such annual and quarterly reports, information, documents and other reports with the SEC, copies of its annual report and other reports . . . which the Company is required to file with the SEC pursuant to Section 13 or 15(d) of the Exchange Act. The Company shall comply with the other provisions of the TIA Section 314(a).

In September 2005, certain holders of one series of BearingPoint's convertible debentures provided a notice of default to BearingPoint, notifying them of the alleged breach of the reporting covenant and that an event of default would occur if this failure continued for 60 days. In November 2005, the same holders sent a notice of acceleration. BearingPoint refused to accelerate, arguing that no event of default had occurred because its SEC reporting covenant required BearingPoint to file copies of its SEC reports with the trustee "if and only if [BearingPoint] files a report with the SEC." The indenture trustee, in January 2006, commenced an action against BearingPoint, seeking acceleration and additional compensatory damages.[18]

The Supreme Court of the State of New York was unconvinced by BearingPoint's argument. The court ruled that the company's failure to timely file its SEC reports constituted an event of default under the SEC reporting covenant, stating that

> Under BearingPoint's interpretation of the [SEC reporting covenant], BearingPoint's obligation to provide information to the Trustee was contingent on whether or not it chose to file with the SEC. [The SEC reporting covenant], however, unambiguously obligates Bearing Pont to make the required SEC filing and to provide copies of them to the Trustee . . . . BearingPoint's tortured parsing of this provision to read the section as making SEC filing optional under the terms of the Indenture, vitiates the clear purpose of the Indenture to provide information to the investors so that they may protect their investment.[19]

Further, the court held that Section 314(a) of the TIA specifically obligates an issuer of notes to provide the indenture trustee with current SEC filings. Having found that an event of default had occurred and the plaintiff holders had given a valid notice of default, the court held that BearingPoint was obligated to accelerate immediately all principal and accrued interest, and having failed to so do, it had breached the acceleration provision of the indenture.

BearingPoint then submitted a motion for reargument, contending that the court had misinterpreted the plain language of the SEC reporting covenant. BearingPoint also noted that it had been unable to file these reports because of problems surrounding its internal controls. Until these problems had been resolved, any financials that BearingPoint filed could be inaccurate. Therefore, BearingPoint argued, its delay in filing did not constitute an act of non-compliance but instead was a required non-action under BearingPoint's obligation not to file materially false or misleading statements as mandated by the Exchange Act. In addition, BearingPoint noted that, while it had been unable to file the reports, it had continued to issue financial disclosures on Forms 8-K that were furnished to the SEC on a regular basis throughout 2005 and 2006, thus appraising investors of its financial situation.[20]

BearingPoint further pointed out that plaintiffs, in their motion for summary judgment, abandoned any demand for acceleration and instead asserted they were entitled to compensatory damages separate from principal and interest. According to BearingPoint, however, plaintiffs had not suffered any damages since both at the time of the court's order and by the time BearingPoint filed its motion for reargument, the notes were trading above par. Therefore, BearingPoint argued, to award damages in this case would result in a windfall for plaintiffs.[21]

In October 2006, the same New York Supreme Court judge who had granted summary judgment to the trustee in BearingPoint ordered the plaintiffs to show cause as to why the case should not be reargued. Before this hearing took place, the parties settled.

Since *BearingPoint*, two reported cases (both in Federal district courts in Texas) have considered the same facts. Both courts held that the reporting covenants in the respective indentures had not been breached.

The first of these decisions is *Cyberonics, Inc. v. Wells Fargo Bank National Ass'n*.[22] Cyberonics was unable to timely file its Form 10-K for 2006 because an internal review of stock option grants had not yet been completed. Having received a notice of default from the indenture trustee relating to an SEC reporting covenant that was substantively identical to the flexible version of the covenant at issue in *BearingPoint*, Cyberonics sued for declaratory relief. It argued that no default had occurred because the reporting covenant in its indenture imposed on it only an obligation to deliver copies of reports, documents, and information after they had been filed with the SEC, not an obligation to timely file.[23]

The trustee contended that the phrase "which the company is required to file with the SEC pursuant to . . . the Exchange Act," which was contained in Cyberonic's SEC reporting covenant, incorporated into the indenture the obligation to file the reports timely. The court disagreed, finding that the reporting covenant:

> unambiguously requires only that Cyberonics deliver copies of the annual reports and other documents to Wells Fargo within 15 days after having filed those documents. The phrase "which the Company is required to file with the SEC pursuant to . . . the Exchange Act" is a modifier of the types of reports that Cyberonics is required to deliver to Wells Fargo, not an additional obligation. Had the parties desired to impose a filing obligation rather than a delivery obligation, they could have easily done so.[24]

The trustee also argued that the parties' intention to impose a filing obligation was reflected by the reference to TIA § 314(a). The court disagreed with this assertion as well. It wrote that, while virtually identical to the reporting covenant in the indenture, Section 314(a)(1) was actually less stringent than the

indenture provision because it did not specify a time frame for providing the reports to the trustee.[25]

The second of these decisions is *Affiliated Computer Services, Inc. v. Wilmington Trust Company*.[26] ACS had issued two series of notes in 2005, each under an indenture containing the flexible version of the SEC reporting covenant, which included the reference to Section 314(a) of the TIA.[27] ACS, like Cyberonics, was unable to file its 2006 10-K on time due to an ongoing internal investigation of historical stock options granting practices. The trustee[28] delivered a notice default alleging that ACS had breached the SEC reporting covenant and had violated Section 314(a) of the TIA. ACS, in response, initiated this action seeking a declaratory judgment that it had not breached the indenture or violated Section 314(a) of the TIA.

The court in *ACS* held that the SEC reporting covenant at issue unambiguously required only that ACS file with the trustee copies of its SEC reports after filing them with the SEC, but did not impose a separate obligation that the SEC filings be timely. In so holding, the *ACS* court formally cited the analysis of the *Cyberonics* decision.[29] The *ACS* court also noted that, if the parties had sought to impose a timely SEC filing obligation rather than a delivery to the trustee obligation on ACS, they could easily have so drafted, again citing to the *Cyberonics* decision.[30] In addition, the *ACS* court held that Section 314(a) of the TIA does not impose a separate obligation on the part of an issuer party to a qualified indenture to file anything with the SEC, but instead requires that the issuer provide to the indenture trustee copies of filings made with the SEC.[31] The *ACS* court then distinguished the holding in the *BearingPoint* decision, both on the basis that it is a decision of a trial court that is not binding on the District Court,[32] and also on the basis that it disagreed with that court's conclusions both as to the meaning of the SEC reporting covenant and the scope of Section 314(a) of the TIA.

The *ACS* court also noted that its holding regarding Section 314(a) of the TIA does not provide issuers with the means to avoid their SEC reporting obligations altogether. While this holding does mean that the issuer cannot be subject to penalties for a late filing under the terms of the indenture (absent a more restrictively-drawn SEC reporting covenant), the court noted that a late filing exposes an SEC registrant to potential sanctions "that are surely adequate" to deter it from intentionally failing to file its SEC periodic reports on a timely basis.[33]

Predicting the future course of litigation always is risky. The progression of cases noted above, however, may support the conclusion that the holding in the *BearingPoint* decision is no longer good law insofar as the more flexible version of the SEC reporting covenant and the related question of the meaning of Section 314(a) of the TIA are concerned. While it is not possible to draw any specific conclusions from the fact that the *BearingPoint* judge took the highly unusual step of considering a rehearing of his initial summary judgment decision, one could reasonably interpret this act to have been motivated by a concern that the initial decision may have been incorrect. Of course, this line of cases has no bearing on the interpretation of the restrictive version of the SEC reporting covenant, which clearly provides that a failure to timely file SEC reports constitutes a covenant breach under the terms of the indenture.

Increased Focus on Covenants in Investment Grade Debt

The concept of "fallen angels"—debt issuers that were investment grade at time of issuance but subsequently were downgraded to sub-investment grade status—cyclically reappears from time to time. The current iteration of this cycle has involved an increase in the number of fallen angels,[34] as well as ratings declines of unprecedented magnitude. These developments largely have been attributable to massive amounts of debt incurred to fund leveraged buyouts or to finance substantial post-buyout dividends to financial sponsors, as well as to the general downward shift in credit quality resulting from ongoing disruptions in the financial markets.

In response, buy-side institutional investors have increased their focus on the quality of protection afforded by investment grade debt covenant packages. One manifestation of this increased focus has been the publication of a white paper by The Credit Roundtable, an association of institutional

fixed income investors that proposes a model set of covenants for investment grade debt offerings.[35] The Credit Roundtable paper touches on the SEC reporting covenant and also on amendment/waiver provisions in multi-series indentures.

As to the SEC reporting covenant, the White Paper notes that in certain instances, investment grade issuers have withdrawn from the SEC's periodic reporting regime, and proposes inclusion of a fallback covenant mandating the provision of financial statements and MD&A-style analysis by issuers that have otherwise exited the SEC periodic reporting regime.[36] This discussion does not address issuers of investment grade debt securities that fail to maintain their status as timely filers under the Exchange Act.

With respect to amendment/waiver provisions, the White Paper notes that market practice is not consistent on this point. As discussed, in some instances approval thresholds are calibrated based on all debt outstanding under the indenture, regardless of how many series this comprises, whereas in other instances approval thresholds are series specific. The proposed model provision would require series-specific voting and consents "where an individual series is of sufficient size to justify this right," without providing any analysis of what constitutes a series of sufficient size.[37]

The focus of the White Paper on SEC reporting issues other than those arising in the context of a restatement or otherwise delayed filing suggests that the institutional investors that produced this paper appear not to view late filings of SEC reports as a significant investor protection issue at this time. This would support the proposition that reporting delays need not necessarily result in acceleration for the debt in question.[38]

Potential Contractual Responses

In response to the *BearingPoint* decision, alternatives to the standard indenture provisions relating to remedies for breach of an SEC reporting covenant have begun to emerge. In this section, we briefly review several of these new formulations, and identify issues that may merit consideration.

The most common new approach provides that a failure to comply with an SEC reporting covenant is not subject to acceleration for some period of time. Instead, the issuer becomes obligated to pay additional interest on the underlying debt securities during that period of time, after which acceleration again becomes an available remedy. This approach typically is paired with the restrictive version of the SEC reporting covenant.

Three approaches have emerged to date.

1. A breach of the reporting covenant is never an event of default, regardless of duration—the only remedy is additional interest. This appears to be an atypical formulation.
2. The additional interest remedy is the sole remedy for a fixed period of time. If the reporting breach remains uncured and unwaived thereafter, it would then constitute an event of default entitling the trustee or requisite holders to accelerate. The period of time for this approach is often 60 or 90 days, but can be longer.
3. In a variant of the second approach, if the issuer fails to comply with the SEC reporting covenant, then additional interest is payable for a fixed period of time (again, typically 60 or 90 days) regardless of the duration of the breach. If the breach has been cured or waived by the end of that period, then no further additional interest is payable and no event of default has occurred. If the breach has not been so cured or waived, then an event of default is deemed to have occurred at the end of such period.

The third approach provides greater economic upside for the investors, as a failure to file for even a few days would trigger the obligation to pay additional interest for a fixed period of time far in excess of that delay. This would provide a disincentive to an issuer that may view paying additional interest for a few days as an acceptable cost of being slightly late in its filing. On the other hand, one could question whether investors are truly harmed by a filing that is late by a relatively brief period of time. Also, for a frequent issuer, the difference between the approaches could result in a significant difference in cost, as it theoretically would have to pay additional interest for the fixed duration across a large

number of debt issuances. We also note that there can be significant adverse consequences to an issuer if it misses SEC filing deadlines, even if only by a few days, so it is not necessary to rely on indenture remedies to protect investors.[39]

Other drafting considerations include the following.

Measurement date for the additional interest period. Some indentures measure the time period during which additional interest is paid from the date of the failure to comply with the SEC reporting covenant. Others require the trustee or requisite holders (typically the same 25 percent required to accelerate the debt) to deliver a notice of breach to the issuer in order to commence the additional interest period. If the additional interest period commences simultaneously with the failure to comply, then the issuer finds itself forced to provide a remedy (additional interest) before the standard grace period would otherwise permit the acceleration remedy to apply. In addition, in deals with an additional interest period of only 60 or 90 days, this approach would not provide a meaningful alternative for issuers, other than forcing earlier payment of additional interest. It thus would appear that the additional interest period should commence, at the earliest, only after passage of the grace period and perhaps also after delivery by the trustee or requisite holders to the issuer of a notice of alleged default. Requiring such a notice replicates the structure of default remedies in general—other than payment defaults and bankruptcy/insolvency defaults, holders must affirmatively take action to trigger a remedy so that the remedy is provided only in instances in which investors perceive themselves to have been harmed.

Duration of additional interest period. Consideration should be given to the time that may be needed to cure a failure to file SEC reports. If the issuer is a large company with complex financial statements, a restatement could take many months to complete, even if the issue is a technical failure to comply with an accounting standard that will not result in a market-moving change to the issuer's financial statements or is the result of commencing a proactive internal investigation of potential stock option granting practices. If the additional interest period is in the 60–90 day range noted above, that may prove to be too short to be meaningful should the issuer have to suspend its SEC reports in order to effect a restatement.

Is the failure to comply during the additional interest period itself an event of default (or an inchoate event of default)? Under any of the alternatives set forth above, the breach of the reporting covenant should not constitute an event of default (inchoate or actual) for so long as additional interest is payable.[40] To provide otherwise runs the risk of triggering cross-default provisions that may exist in other financing documents, which is inconsistent with the intent of this alternative remedy structure.

Amount of the additional interest. This typically is calibrated in basis points, on the order of 25 to 50 basis points per annum for so long as the additional interest is payable. It also is possible to have tiered additional interest obligations, *e.g.*, 25 basis points for the first half of the additional interest period, with a step up to 50 basis points thereafter. If the issuer seeks an additional interest period that will fall on the longer side of the market range, then one or more step-ups in rate during that period may be appropriate.

Does the additional interest approach only work with the restrictive version of the sec reporting covenant? It would be possible to use this approach with the flexible version of the SEC reporting covenant. This would appear to be necessary only if the issuer was concerned that a court might interpret Section 314(a) of the TIA to impose an obligation to file Exchange Act reports on a timely basis, or that a court might interpret a flexible version of the reporting covenant as if it were drafted in the restrictive formulation (in each case, as the court held in *BearingPoint*).

Should this approach also apply to other covenants? As noted, the strategy underlying the institutional investor activism described herein need not necessarily apply only to the SEC reporting covenant. Care should be taken in drafting non-financial covenants such that technical non-compliance or brief periods of breach do not ineluctably lead to acceleration as the only remedy for investors. One means by which to address such a concern would be to use a version

of the additional interest approach in the event of a failure to comply with such a covenant, with acceleration remaining a remedial option after passage of some clearly defined period of time.

Clarity is key. Regardless of the approach taken, the final covenants and remedy provisions in the indenture must be clearly and carefully drafted, as they are likely focal points, should difficulties subsequently ensue.

Conclusion

Recent institutional investor activism in the fixed income markets has taken advantage of traditional documentation structures to leverage arguably minor breaches of non-financial covenants into events that threaten the very existence of otherwise viable issuers. Documentary responses that more carefully calibrate contractual remedies to the breaches they address have begun to emerge. Given current transactional velocity, it is often difficult to find time to evaluate carefully new versions of previously-long standing indenture provisions. This careful review and analysis is nonetheless important to ensure that the structure that is adopted reflects the parties' intent.

NOTES

1. In the realm of criminal law, the 8th Amendment's prohibition on cruel and unusual punishment requires that any sentence or fine be commensurate with the gravity of the offense and the criminal record of the defendant. *See* Black's Law Dictionary 664 (definition of "excessive fine") and 1270 (definition of "excessive punishment") (8th ed. 2004).
2. *See, e.g*., Marcus Tullius Cicero, De Legibus, III, 20 ("Let the punishment match the offense.").
3. *See, e.g*., Charles M. Fox, Working With Contracts—What Law School Doesn't Teach You (2002) at pp. 26–27 ("[A]cceleration often has catastrophic consequences. Usually, the mere threat of acceleration is sufficient to cause the defaulting party to make significant concessions in exchange for the lender agreeing not to accelerate.")
4. The line between "bank finance" and "leveraged finance" is blurry at best, particularly since the end of the separation of commercial and investment banking mandated by the Glass-Steagall Act. As we only refer to non-capital market financing for purposes of distinguishing it as a historical alternative from accessing the capital markets, for purposes of this article we arbitrarily choose to refer to this by its historical name of bank finance, fully understanding that this form of financing can be provided by entities that are not banks.
5. We note that what we refer to below as institutional investor activism in the fixed income capital markets can, of course, occur in the bank finance market as well since hedge funds and other non-bank institutional investors have become active participants in the secondary loan trading markets, and also are frequently members of the lending syndicate. These investors can seek to acquire sufficient positions in a bank credit facility to force acceleration and block waivers, as we describe below in the context of the capital markets. In response to this, however, bank documentation increasingly requires prior approval of the administrative agent (and, in some cases, the borrower) to secondary transfers of the loans, such that such investors can be prevented from amassing a sufficiently large position. This control structure is not available in the capital markets.
6. In offshore capital markets transactions, the tendency of investors to hold their securities in bearer rather than registered form makes it more difficult to identify and locate beneficial owners, and thus further complicates this analysis.
7. The analysis that follows is, as a general matter, equally applicable to debt securities issued in the offshore markets, whether under indentures or Fiscal Agency Agreements, and whether those instruments are governed by NY or UK law. The note (or debenture or bond) itself, a form of which is appended to the indenture or Fiscal Agency Agreement, also may contain remedy provisions. For ease of reference, the discussion of remedy provisions herein will refer to indentures, but will include Fiscal Agency Agreements and also the actual note or similar instrument.
8. Trustees typically require an opinion from counsel that the proposed amendment is not adverse to the holders.
9. Any such structure would, of course, be subject to limits imposed by board resolution or other corporate authorization and, in the case of publicly offered securities, existing capacity under an effective shelf registration statement.
10. This potential cost is exacerbated in many indentures, which contain a covenant requiring that if the issuer pays a consent fee, it must pay the same fee to all affected holders under the indenture, such that if a holdout is able to procure an increased payment, the issuer must increase the fee paid to all other holders of the affected securities.
11. Commentators often refer to this as "hedge fund activism." While it is true that many of the parties engaging in this behavior are hedge funds, there is nothing in this structure that requires a participant to be a hedge fund, nor is it true that hedge funds are the only participants. We therefore refer to this behavior more generically as institutional investor activism.
12. This assumes that the indenture is qualified under the Trust Indenture Act, which is a requirement for any indenture used to offer debt securities in transactions registered with the SEC. If the securities are issued in offshore transactions or private placements pursuant to exemptions from SEC registration, then TIA qualification is not generally required and thus the requirements of Section 314(a) of that act need not be included. In the case of an unregistered fixed income transactions effected pursuant to Rule 144A under the Securities Act, however, the underlying indenture typically is TIA compliant.
13. According to Treasury Secretary Paulson, in 2006 there were 1,876 financial restatements, involving over 10 percent of companies filing

periodic and other reports with the SEC. This compares with 116 restatements in 1997. Press Release, United States Department of the Treasury, *Paulson: Financial Reporting Vital to US Market Integrity, Strong Economy*, release HP-407 (May 17, 2007), available at *www.treasury.gov/press/releases/hp407.htm*. *See also* United States Government Accountability Office, Report GAO-06-678, *Financial Restatements—Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities* at p. 4 (July 24, 2006, as reissued and updated on March 5, 2007) (the number of companies announcing financial restatements from 2002 through September 2005 rose from 3.7 percent to 6.8 percent, a 67 percent increase over the period).

14. Rule 10-01(d) of Regulation S-X and Rule 310(b) of Regulation S-B.

15. Division of Corporation Finance Current Accounting and Disclosure Issues Topic II.S. (August 31, 2001), available at *www.sec.gov/divisions/corpfin/acctdisc#P515_113052*; *see also* AICPA Practice Alert 2000-4, "Quarterly Review Procedures for Public Companies," available at *www.aicpa.org/pubs/cpaltr/oct2000/supps/palert1.htm*.

16. This form of investor activism also can in theory be applied to covenants other than the SEC reporting covenant, if the alleged or actual breach is not capable of being cured within the cure period typically provided for non-financial covenants. Examples could include alleged non-compliance with a maintenance of insurance covenant (if the issuer is not able to retroactively provide the coverage alleged to have not previously been provided) or a line of business covenant (these are often broadly written and contain subjective standards compliance with which may be difficult to establish, yet an allegation could be crafted so as to force the issuer to take steps that management deems not to be in the best interest of stockholders). We also are aware of a situation in which institutional investors used this approach to allege that an issuer of debt securities in a Rule 144A transaction with registration rights committed a payment default under the indenture on the second anniversary of the issuance date of the notes when it stopped paying additional interest for failure to file the resale shelf registration statement. Although market practice generally has been understood to provide that the duration of the obligation to pay additional interest for a registration default in a Rule 144A transaction continues only for so long as the securities remain restricted under Rule 144 when held by non-affiliates (which was two years from the time of issuance in the transaction in question), the investors alleged that the documents did not clearly so provide and thus the issuer was obligated to pay additional interest for the remaining life of the notes if it failed to file and have declared effective the required resale registration statement. The parties settled their dispute before this claim was analyzed by a court.

17. *The Bank of New York. v. BearingPoint, Inc*., 824 N.Y.S. 2d 752 (N.Y. Sup. Ct. 2006) (bench decision) also available at *http://www.courts.state.ny.us/reporter/3dseries/2006/2006_51739.htm*.

18. The action was commenced by the indenture trustee at the behest of the institutional investor that held sufficient debentures to be able to deliver the notice of acceleration notice, Linden Capital, L.P. It appears that institutional investors that initiate actions such as this prefer that the trustee appear as nominal plaintiff rather than the investors. Given the trustee's fiduciary duty to noteholders if a default has occurred, it is difficult for a trustee to decline to do so.

19. *BearingPoint*, *supra* n.17 at p. 10 of the Web site version of the opinion.

20. Memorandum of Law in Support of Defendant BearingPoint, Inc.'s Motion for Reargument and Renewal of Plaintiff's Motion for Summary Judgment, *The Bank of New York v. BearingPoint Inc*. (Oct. 16, 2006) at p. 9.

21. BearingPoint also argued that new facts had been developed since the briefing of the summary judgment motions, including facts suggesting that opportunistic hedge fund investors were targeting distressed public companies such as BearingPoint after reporting delays had came to light. *Id.* at pp 1–2, 7–8.

22. *Cyberonics, Inc. v. Wells Fargo Bank National Ass'n*, slip opinion, 2007 WL 1729977 (S.D.Tex.) (June 13, 2007).

23. The relevant provision in the *Cyberonics* indenture was substantively identical to the covenant at issue in *BearingPoint*.

24. *Id.* at p. 7.

25. *Id.* at pp. 7–8.

26. *Affiliated Computer Services, Inc. v. Wilmington Trust Company*, slip opinion, Civ. Action. No. 3:06-CV-1770-D (Feb. 12, 2008).

27. The relevant provision in the ACS indenture was also substantively identical to the covenant at issue in *BearingPoint*.

28. Wilmington Trust succeeded to the trusteeship of the notes from The Bank of New York, the original trustee.

29. *ACS, supra* n.26 at pp. 7–8.

30. *Id.* at p. 8.

31. *Id.* at pp. 10–14.

32. The *ACS* court noted that, because New York law governs the ACS indenture, a final decision of the highest New York State court would have been relevant. *Id.* at pp. 17–18.

33. *Id.* at p.17. *See, e.g.,* Securities and Exchange Commission Litigation Release No. 18020 (March 7, 2003) (SEC charges Spiegel, Inc. with fraud and violation of Exchange Act reporting requirements for failing to file required 10-K and 10-Q reports to conceal receipt from its auditors of a report stating the auditors had substantial doubts about Spiegel's ability to continue as a going concern). In addition to potential sanctions for late filings imposed by the Federal securities laws, there are also significant adverse consequences that can affect a registrant's access to the capital markets. *See* Hansen, Lee & Morrow, "Consequences of Untimely Periodic Reports Under the Exchange Act," *Insights*, Vol. 21, No. 2 at pp.8–14 (March 2007).

34. Standard & Poor's recently announced that the number of investment grade companies that have fallen to sub-investment grade status is at its highest level in nine years, and that the volume of affected debt nearly doubled in 2007 as compared with 2006. *See* Stephanie Baum, "Fallen Angel Companies Highest Since 1999," *Financial News Online US* (Feb. 27, 2008) (available at *www.financialnews-us.com/?page=ushome&contentid=2349905605*).

35. The Credit Roundtable, Improving Covenant Protections in the Investment Grade Bond Market (Dec. 17, 2007), available at *www.creditroundtable.org.*

36. *Id*. at p. 6 and Rider 4 of Annex A thereto.

37. Credit Roundtable, *supra* n.35, at pp.6–7 and Rider 5 of Annex A thereto, including the footnote to Rider 5.

38. We also note that a product introduced by Moody's Investors Service in November 2006 to evaluate indenture covenants and assign covenant quality assessments did not focus on the SEC reporting covenant or the calibration of the amendment/consent provision. Moody's Investors Service, "Moody's Approach to Evaluating Indenture Covenants and Assigning Covenant Quality Assessments" (Nov. 2006), available at *www.moodys.com/moodys/cust/research/MDCdocs/27/2006200000424929.pdf?frameOfRef=corporate*. In its request for comment on the framework, Moody's explicitly noted that it was focusing on covenants that could protect bondholders from "event-driven credit risk," citing to companies that had recently become fallen angels (such as Sungard, First Data, VMU and Telstra). Moody's Investors Service, "Request for Comment on Moody's Indenture Covenant Research & Assessment Framework" (Sept. 2006) available at *www.moodys.com/moodys/cust/research/MDCdocs/13/2005800000428263.pdf*.

39. *See supra* n.33.

40. Of course, if the issuer fails to pay additional interest when it is contractually obligated to do so, that would constitute a payment default.

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