HUNTON& WILLIAMS

CLIENT ALERT

December 2008

Contacts

Daryl B. Robertson
(214) 468-3371
drobertson@hunton.com

William H. McBride
(919) 899-3030
wmcbride@hunton.com

Timothy S. Goettel
(919) 899-3094
tgoettel@hunton.com

David E. Wells
(305) 810-2591
dwells@hunton.com

W. Lake Taylor, Jr.
(804) 788-8563
tlake@hunton.com

J. Steven Patterson
(202) 419-2101
spatterson@hunton.com

Michael Nedzbala
(704) 378-4703
mnedzbala@hunton.com

Ronald J. Lieberman
(404) 888-4139
rlieberman@hunton.com

Jerry E. Whitson
(212) 309-1060
jwhitson@hunton.com

Dealing With Bondholders In Troubled Times

Most public companies have outstanding one or more series of bonds (or notes) that are held by third-party, mostly institutional, investors. Any of these companies that are experiencing financial difficulties may wish, or may be forced, to deal with the holders of their outstanding bonds in order to reorganize the company's debt structure, to reduce its debt, to permit an acquisition or disposition transaction to occur or to amend restrictive covenants. In addition, during troubled economic times, these bonds are often traded at deep discounts from their face principal amounts as a reflection of the market's view of the financial condition and future prospects of the issuing company. Sometimes the bonds are acquired by opportunistic investors (a.k.a. "Vulture funds") that are intent on forcing declarations of default and acceleration of the bonds or otherwise realizing quick profits on their investments in the bonds.

As is often the case, dealing with individual bondholders can be difficult because of their number. The indenture trustee appointed pursuant to the trust indenture governing the bonds will usually act on behalf of the bondholders in their interactions with the issuer. However, the nominal annual fee paid for standard trust services provides little incentive for an indenture trustee to spend much time in representing the bondholders in troubled situations. As a result, the initial bond trustee will often resign, and a substitute trustee must be located to serve in that capacity.

A very recent court case illustrating some of the issues that can be raised by bondholders is found in *United Health Group Inc. v. Wilmington Trust Co., in its capacity as Indenture Trustee*, Case No. 08-1904, opinion filed December 1, 2008, United States Court of Appeals for the Eighth Circuit. In that case, United Health Group Inc. ("United") failed to timely file a Form 10-Q with the Securities and Exchange Commission ("SEC"). A notice of default was sent to United on behalf of certain hedge funds that collectively owned more than 25 percent of the outstanding principal balance of United's 5.8 percent senior notes due March 15, 2036. After analyzing the terms of the trust indenture and applicable law, the court concluded that United was not in default because it had not violated its obligations under the trust indenture to provide the indenture trustee with copies of its periodic reports within 15 days after filing with the SEC.

There are many legal considerations that need to be taken into account when an issuer deals with its bondholders and the indenture trustee.

→ The legal rights and obligations of the issuer, the trustee and the bondholders with respect to the bonds are generally governed by the trust indenture. If the indenture is ambigu-

ous on an issue, a court may look to the description of the bonds in the bond-offering documents for an interpretation of the indenture's provisions. However, discrepancies between the description of the bonds in the bond-offering documents and actual clear provisions in the indenture will usually be resolved in favor of the indenture.

- Most indentures will be governed by the Trust Indenture Act of 1939, as amended (the "TIA"). The TIA applies even to debt securities issued in transactions otherwise exempt from registration under Section 3(a)(9) or (10) of the Securities Act of 1933, as amended ("Securities Act"), as well as debt securities issued in connection with bankruptcy reorganizations. The TIA specifies that certain of its provisions will be deemed part of the indenture. Modern American indentures follow the American Bar Association's Model Debenture Indenture. This form document, with general explanations of the provisions included, was drafted by a prestigious group of corporate attorneys in the last century, including, as one of the leaders, George Gibson, a former name partner in Hunton & Williams.

- The provisions of the trust indenture and the TIA should be reviewed for the rights of bondholders to declare an event of default and to accelerate the maturity of the bonds, to instruct the trustee to exercise remedies against the issuer on behalf of the bondholders, and to waive defaults by the issuer as well as the right of individual bondholders to directly sue the issuer for payment of the bonds. Trust indentures may also contain important restrictive covenants concerning the issuer's financial condition and results of operation that must be observed by the issuer. In addition, the document should be carefully reviewed for (a) the issuer's rights to replace the indenture trustee or to approve a new trustee if the old one is removed by the bondholders and (b) the possibility the indenture may be amended without the consent of the bondholders in a manner that will alleviate the troublesome situation.

- If the indenture cannot be amended without consent, it is often true that less than all the holders need to consent to an amendment that will solve the problem. Therefore, consideration should be given to tendering for or otherwise reducing the outstanding amount of bonds or directly soliciting the necessary bondholder consent.

- Tender offers or exchange offers by an issuer for its debt securities will be impacted by a number of important securities laws. In particular, Rule 14e-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") has requirements for how long a tender offer must remain open, for the timing of payment for tendered securities after expiration of the offer, for any extensions of an open tender offer, and other important rules that must be observed. An exchange offer must either (a) be exempt from registration under the private offering exemption or the exemption for exchanges of securities under Section 3(a)(9) of the Securities Act or (b) be registered on a Form S-4 or F-4 with the SEC. In the case of an exchange offer, the TIA will usually require the trust indenture for the new debt securities offered in the exchange offer to be registered with the SEC and meet the other requirements of that statute.

- Consent solicitations of bondholders by the issuer are often used to effect a change in the covenants. These solicitations by themselves are not subject to Rule 14e-1 but are often combined with a tender or exchange offer that is subject to that rule. Consideration paid to consenting bondholders must be carefully structured to avoid potential liability under applicable court cases that require the consideration to be offered on the same terms to each holder of the affected debt security. Provisions in the trust indenture may also impact the ability to make consent payments to only consenting bondholders.

- In the case of any consent solicitation, tender offer or exchange offer, the general antifraud rules of the securities laws will be applicable. The written disclosures provided to bondholders in connection with any of the foregoing transactions must be carefully prepared to avoid any possible claims of false or misleading disclosures that might be actionable under applicable securities laws.

- Note that if the bondholder group is large, there can be real problems communicating with them through the book-entry system. DTC will not provide a list of holders of an issuer's bonds — only a list of

the authorized contacts for each participant holding the securities. That list then has to be worked with to laboriously develop a bondholder list. There are private companies who, for a price, will supervise a bondholder solicitation.

- In general, the officers and directors of a company do not owe duties to bondholders, such as the duties of care, loyalty and good faith that they may owe to the company's shareholders. The relationship between bondholders and the issuing company is considered contractual in nature. However, when a company is in the "vicinity" or "zone" of insolvency, the duties of the company's officers and directors may shift and expand to include creditors and other stakeholders (e.g., employees) of the company. Creditors have a right to expect that the directors and officers will not divert, misappropriate or unduly risk the company's assets in an effort to avoid claims of creditors, including the bondholders. Officers and directors must consider the interests of the company's entire "community of interest." Obviously, these expanded duties may cause conflicting expectations and problems in planning the company's future.

- Extraordinary corporate transactions by the issuer will often trigger issues with respect to bondholders. The trust indenture usually has a provision that is triggered by a merger with another entity or the sale, transfer, lease or other disposition of all or substantially all of the issuer's assets to another entity. These provisions typically require that the issuer's obligations under the trust indenture must be assumed by the transferee or successor. Spin-offs of corporate assets to shareholders are often questioned by bondholders and can be an impetus for litigation concerning the purpose and effect of the spin-off. Likewise, sales of important assets may raise issues of successor liability. Bondholders and trustees might assert that the purchaser is liable for the indebtedness represented by the bonds. Caution should be exercised in connection with these kinds of transactions to make certain that bondholder rights are addressed.

Care must be taken by a public company in dealing with bondholders and their indenture trustee. As can be seen from the foregoing summary, there are numerous important legal considerations. Hunton & Williams attorneys have substantial experience in these matters. For example, current attorneys in this firm have:

- Supervised bondholder meetings at which workout possibilities, litigation and other matters were discussed and voted upon.

- Prepared documents for consent solicitations, tender offers and exchange offers to bondholders.

- Drafted notices to bondholders regarding many points, including actual defaults, their rights, the status of the trust estate and the status of litigation.

- Worked with committees of bondholders formed to advise indenture trustees on actions to take.

- Served as an expert witness concerning the interpretation of bond indentures in a lawsuit arising out of a proposed $10 billion+ merger/acquisition.

- Obtained a preliminary injunction against finalization of a restructuring without bondholder consent, which would otherwise have been harmful to the rights of certain bondholders.

We have the necessary litigation and corporate finance experience with respect to these kinds of transactions with bondholders to provide sound advice to our clients. Please let us know how we can assist you.

Contact: Walfrido J. Martinez*, Hunton & Williams LLP, 200 Park Avenue, New York, NY 10166, (212) 309-1000. *Licensed to practice in Florida and New Jersey only.