

UPDATE: Using Incremental Facilities to Exchange Bond Indebtedness - The Realogy Decision

By Nicholas A. Whitney and Douglas R. Plante

On December 17, 2008, we distributed a memorandum entitled “Using Incremental Facilities to Exchange Bond Indebtedness”.¹ As noted in the memorandum, a lawsuit was filed by the Trustee with respect to the Indenture (the “PIK Notes Indenture”) for the unsecured “PIK toggle” notes (the “PIK Toggle Notes”) of Realogy Corporation (“Realogy”) and High River Limited Partnership (“High River”), a holder of the PIK Toggle Notes, as plaintiffs, against Realogy, as defendant (the “Realogy Case”).

On December 18, 2008, the Court rendered its decision in the Realogy Case. This memorandum provides a brief summary of the Court’s opinion.²

Background of the Case

Realogy’s capital structure contains several layers of indebtedness, including secured bank debt, the PIK Toggle Notes,³ unsecured senior notes (the “Senior Cash Notes” and together with the PIK Toggle Notes, the “Senior Notes”) and unsecured senior subordinated notes (the “Senior Subordinated Notes”).

In mid-November Realogy made an offer to eligible noteholders to exchange their notes for new second lien term loans to be borrowed under the incremental facility in Realogy’s Credit Agreement. The offer promised that, rather than receiving cash, noteholders would tender their notes in exchange for the new second lien term loans. According to the terms of the exchange offer, the holders of the Senior Subordinated Notes

had first priority to exchange their notes, with the holders of the Senior Cash Notes next in line and the balance of the exchange (if any) available to the holders of the PIK Toggle Notes. Noteholders who accepted the offer would receive a reduced price from the par value of their notes in exchange for a senior secured position in Realogy’s capital structure.

Following the announcement of the exchange offer, High River and the Trustee under the PIK Notes Indenture filed a lawsuit requesting that the Court (i) declare that the consummation of Realogy’s proposed exchange offer would violate the terms of the PIK Notes Indenture and (ii) enjoin Realogy from consummating the proposed exchange offer because the exchange would constitute a fraudulent transfer. Underlying the lawsuit is the concern of High River and the Trustee that if the contemplated exchange were to occur and the holders of the PIK Toggle Notes were accordingly last in line to receive the exchange, any Senior Subordinated Notes and Senior Cash Notes exchanged for the new second lien term loans would effectively take a priority position over the PIK Toggle Notes in any potential bankruptcy proceeding.

The main arguments against the exchange offer were that (i) the exchange was not permitted under the Credit Agreement because the Credit Agreement required that the second lien term loans be funded with cash, (ii) the lien securing the second lien term loans was not permitted as an exception to the lien covenant under the Credit

Memorandum

January 7, 2009

“After the Court’s decision was announced, Realogy withdrew its offer to make the exchange....”

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¹ For a copy of our memo, please refer to our website at <http://www.rkollp.com/publications.php>.

² The full text of the opinion of the Chancery Court of the State of Delaware may be found at <http://graphics8.nytimes.com/images/blogs/dealbook/realogyopin121808.pdf>.

³ “PIK toggle” notes permit an issuer to elect to pay interest on either a paid-in-kind basis or in cash.

Agreement and therefore would violate the provisions of the PIK Notes Indenture and (iii) the exchange offer constituted a fraudulent transfer.

The Court's Opinion

The Court's opinion held that the terms of the Credit Agreement did not permit Realogy to grant a lien on its assets in order to secure the second lien term loans and, therefore, the proposed second lien term loans were not permitted under both Realogy's Credit Agreement and the PIK Notes Indenture. The Court (i) disagreed with the plaintiffs' argument that the second lien term loans were required to be funded in cash in order to constitute loans under the Credit Agreement, and (ii) did not address the extra-contractual argument that the exchange constituted a fraudulent transfer. In response to the Court's decision, Realogy terminated the exchange offer.⁴

Interestingly, the Court's analysis focused on the following provisions contained in the PIK Notes Indenture and the Credit Agreement:

- The PIK Notes Indenture permits debt which is incurred "under the Credit Agreement".
- The Credit Agreement permits the refinancing of the Senior Notes, so long as the debt refinancing the Senior Notes (which would include the contemplated exchange of the new second lien term loans for the Senior Notes) is "Permitted Refinancing Indebtedness" permitted to be incurred under the Credit Agreement.
- "Permitted Refinancing Indebtedness" permits indebtedness which refinances the Senior Notes so long as the refinancing indebtedness does not have "greater guarantees or security, than the Indebtedness being Refinanced" unless the security interest "*may be added*. . . under Article VI [the negative covenants]" (emphasis added).

The Court centered its decision on whether the security interest that would secure the new second lien term

loans was the type of security interest which "may be added" to the indebtedness refinancing the Senior Notes. Realogy argued that since the lien covenant contained in the Credit Agreement permits and obviously contemplates the security interest on the existing loans borrowed and to be borrowed under the Credit Agreement (which would include the new second lien term loans to be borrowed under the incremental facility), the security interest on the second lien term loans "may be added" in connection with the refinancing of the Senior Notes. In contrast, the plaintiffs argued that any security interest on indebtedness refinancing the Senior Notes "may be added" only if the lien covenant contained an exception permitting a lien on the Senior Notes prior to the refinancing. In other words, if the Senior Notes were permitted to be secured by a lien under another exception to the lien covenant, then the refinancing debt could also be secured by a lien relying on this exception.

The Court concluded that because the lien covenant does not contain an exception which would permit Realogy's Senior Notes to be secured by a lien, the lien on the second lien term loans refinancing the Senior Notes was not permitted under the definition of "Permitted Refinancing Indebtedness." Based on this conclusion, the second lien term loans are not permitted "under the Credit Agreement" and therefore are not permitted under the PIK Notes Indenture. The Court decided that under these facts the debt exchange could not be consummated as originally offered to the noteholders.

The Court noted the irony of having its decision hinge on the interpretation of a Credit Agreement in which the Trustee is not a party, and the Court left open the possibility that the senior lenders could amend the Credit Agreement in order to permit the lien on the Permitted Refinancing Indebtedness. After the Court's decision was announced, Realogy withdrew its offer to make the exchange; however, Realogy could seek an

⁴ See Realogy Corporation's Form 8-K filed on December 18, 2008, available at <http://idea.sec.gov/Archives/edgar/data/1355001/000119312508256016/d8k.htm>.

amendment to the Credit Agreement to permit the exchange offer sometime in the future.

Conclusion

The Court’s decision in Realogy does not preclude all debt exchange offers using incremental loans, rather it turned on the interpretation of a single provision in Realogy’s Credit Agreement as to whether a security interest “may be added” to secure indebtedness that refinances unsecured indebtedness. In light of the increasing frequency of attempts to use such cashless tenders to refinance a borrower’s capital structure, the decision highlights the need for parties to review each credit agreement and each indenture thoroughly and carefully when contemplating a debt exchange offer. As noted in our prior memorandum, documents vary and may contain unique language that could limit a company’s ability to consummate an exchange.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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